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FISCAL POLICY, TAXATION AND FREE ENTERPRISE

by

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Basic Principles of Economics

The Economic Basis of Tax Reform

The Economics of Taxation

etc., etc.

LUCAS BROTHERS
COLUMBIA, MO.
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PREFACE

This little book is in some sense a postscript to my BASIC PRINCIPLES OF ECONOMICS. Most of its chapters, indeed, merely develop further various topics already touched on in that book. The present smaller and supplementary publication I plan to assign — at any rate the greater part of it — as additional reading in my course in the "principles" of economics.

Yet this present study, dealing as it does with problems of fiscal policy (including war finance) and taxation, might with about equal plausibility be regarded as a postscript to my two previous books on taxation, viz., THE ECONOMICS OF TAXATION (1924, reprinted in 1938) and THE ECONOMIC BASIS OF TAX REFORM (1932). In particular, I have many times regretted that "The Incidence of a General Output or a General Sales Tax", which appeared in *The Journal of Political Economy* in April of 1939 (with "A Correction" added in June), came too late for inclusion even in the 1938 reprinting of THE ECONOMICS OF TAXATION.

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H. G. B.

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FISCAL POLICY, TAXATION AND FREE ENTERPRISE

I

Fiscal Policy and War-time Price Control

IN A SYSTEM OF FREE enterprise and free markets, the fundamental forces determining the relation of the price of one commodity to that of another are the forces of demand and cost. The average of all prices—what we often speak of as the general level of prices—is largely a function of the volume of the circulating medium and the readiness of the people to spend it. A large increase in the circulating medium in proportion to available goods usually and, indeed, almost inevitably, raises the average of commodity and other prices, while a great proportionate decrease—e.g., from a sharp restriction of bank credit—brings the average of prices down.

The circulating medium includes, as its largest element, bank deposits on which checks are written. These deposits subject to check are increased when banks lend freely and also when banks purchase commercial drafts, mortgages or government bonds. When banks make such purchases, of course, they give checks and, therefore, bank deposit accounts for the paper or securities involved. So, when a government finances its war expenditures largely by borrowing from the banks, selling to the banks its own bonds or short term promissory notes and thereby obtaining checking accounts to use for paying for material for its military and naval needs, there is, ordinarily, an increase of the circulating medium, increased spending by the government and by those from whom the government purchases its supplies and by the workers they hire. Almost inevitably there is a bidding for goods and services all along the line and, in consequence, a general rise of prices.

It is true that increased bank credit extended to government might go along with decreased credit extended to private individuals and corporations. Such price-level increases would not then result. It is also quite possible—indeed, this has often happened—for credit extended to private business to increase so greatly in peace-time as to bring about a very considerable rise of prices. The recent policy of the United States of buying at $35 an ounce any gold, offered from any part of the world, has meant vast increases of bank reserves and so of the lending power of the American banking system. For this policy has tended to swell American exports which could be paid for with this gold; and the banks, in bringing in the gold and disposing of it to the United States Treasury, have received larger reserves. In our present inquiry the details of bank credit expansion and its relation to reserves are not important. Suffice it to say that, when World War II began, the banks were in such a position that a very considerable expansion of credit, given the demand for it, was easily possible.

But, then, it is argued (even by some of those who realize that increase of bank loans to government and to others is inflationary, and who would perhaps like to see limitations put on such increase of bank loans) that much can be done through direct price-fixing. It is thought that the government need not limit quite so rigidly the volume of money and bank credit, particularly of the latter. It is noted that the sale to individuals of savings bonds, on which bank loans cannot be made, does not provide all the war revenue that is needed. Taxes are increased, but there is legislative hesitation in increasing them *enough* to meet pressing military requirements. And so government borrowing from the banks—

which tends strongly toward inflated prices and a grossly unfair distribution of war's burdens—is resorted to as a means of obtaining the remainder of the needed funds. Then the advocates of direct government price-fixing—like the man who would have his cake and eat it too—come forth with the proposal that this borrowing from the banks and the great increase in the circulating medium and so of the spending power resulting from it, shall be prevented by price-raising prohibitions from having its normal effect. The government will thus get its desired funds from the banks but prices will not—shall not—rise. What are the chances that such regulation would be successful?

Wherever price-fixing has been attempted with prices fixed much below their normal market level, there seems to have developed a "black market." In other words, there is extensive evasion of the price-fixing law. Goods are smuggled out of warehouses and sold, more or less secretly, to persons willing to pay prices that are above the legal ones. Sometimes purchasers who pay, formally, only the legally-fixed price, have been required first to lease the article to be purchased and have thus actually paid a rental in addition to the formal purchase price.[1] Often, too, it is easy to take advantage of consumers who do not know or perhaps cannot remember what the maximum legal prices are on the numerous articles they must buy. Effective enforcement may then require numerous investigators and great expense. In some cases, even, goods are stolen and then sold by the thieves, of course usually at prices above those supposedly—and, perhaps, generally—adhered to by legitimate dealers. The variety of particular circumstances may be numerous. But in all of the special cases there is the one underlying influence,

[1] *Bread and Butter*, published by Consumers Union, New York, July 24th, 1942.

viz., that a low price is fixed by law or administrative regulation on a scarce commodity so desired that many persons would far rather pay a higher price than go without. When that is so, it is almost certain that at least *some* would-be buyers will take part consciously in a conspiracy to violate the law, while not a few others will pay illegal prices through ignorance.[2]

Again, even if "ceiling prices" are otherwise hard to evade, much can perhaps be done to thwart regulation by lowering quality. The price set for a commodity that has been pretty much standardized is applied to an article that looks a good deal the same but is actually of inferior quality and cheaper to make. Or perhaps, in the case of various mechanical gadgets, old models may be discontinued and new models, for which a higher charge is made, substituted. Such practices certainly complicate the problem of enforcement and make for relatively frequent evasion.

But no study limited to direct evasions or violations of price-fixing regulations will begin to give the picture of how an increase of the circulating medium brings about price rises despite the activities of a price-fixing agency. For in fact a large part, or most, of the increases that occur are allowed—not to say encouraged—by the regulating legislation or the regulating administrative agency or both.

The first barrier to successful regulation of prices in the United States during the present war emergency was the provision by Congress that no price "ceilings" should be fixed on farm products lower than 110 percent of "parity." Farm prices are regarded as being at "parity" when they are as high, compared to other prices, as in the years 1909–1914. They were then relatively higher than they have usually been since

[2] Mr. Leon Henderson, OPA Administrator, has pointed out that "to forbid a thing does not prevent it," recalling American experience with the Prohibition Amendment. *Cf.* his address, Norfolk, Va., Aug. 20, 1942.

or than they had been for some time before. Recent Federal legislation and crop restricting regulations provided for in such legislation have been designed to maintain this 1909–1914 favorable relation. But to say that farm prices are not to be held to less than 110 percent of parity was to say, right at the start of price regulation, that for these goods, at least, price regulation would amount to comparatively little. And if these prices are allowed to rise by this amount, prices of goods made from them may have to rise. If wheat is higher, can the price of flour be kept down? If corn is higher, will men feed the corn to hogs unless their price is also higher? If hogs, too, are higher, will butchers—especially when other work is available at high wages—butcher and sell the pork for a low price?

Then there is the matter of wages. Wage increases have recently been allowed by the War Labor Board on the ground that such increases are justified by the higher cost of living. But if certain raw materials, e.g., from the farms, are permitted to rise in price and if, then, wages and, perhaps, other business expenses are also permitted to rise, will not finished products rise in price also? How shall this be prevented? Consider the manufacturer who has to pay more for raw material than before—e.g., for cotton—*and* to pay higher wages and, possibly, higher interest on capital or more rent for a valuable site (the prohibition of increases in residential rents does not of itself prevent business rents from rising). Will the Office of Price Administration require him to keep down the price of his finished products even if he thereby loses money? In that case he will certainly quit and the public will not get the finished products at all. And even if he could be forbidden to quit, by the threat of a jail sentence, he could be forced to continue production only until he became bankrupt. After that he simply *could not* continue

production, other than by cheating his creditors or by doles from his friends; he would have to endure the jail sentence if so required.

The above comments are not intended as a criticism of the War Labor Board for ordering certain wage increases. And they are not intended to convey an impression that executives and employing companies are being discriminated against. A recent report of Consumers Union[3] contends that the greater part of the current increase in purchasing power has gone to persons whose incomes were already $5,000 or more a year and that, in fact, considerably more than half has gone to persons already receiving as much as $10,000 a year. While the fight which finally brought up money incomes for workers in "Little Steel" by 15 percent was under way, Consumers Union remarks, twenty-five large companies increased their executives' salaries by "anywhere from $20,000 to $100,000 a year." Obviously, regardless of whether wages of ordinary workers are or are not going up faster than—or as fast as—other and initially higher incomes, it must be noted that interest on borrowed funds, rentals and executives' salaries are part of the expenses of business as truly as are wages of artisans and day laborers. Where and if all of these go up and the prices of raw materials go up, it is hardly to be expected that the prices of finished products will be kept down.

It is of interest to note that the Office of Price Administration in the summer of 1942 permitted fruit and vegetable canners to raise the price of the 1942 pack by 15 to 25 percent above the March "ceiling" because of "increased costs."[4] How many of these price increases can take place without the problem arising of further wage increases to offset "increased living costs" and, eventually, of further increases in the prices

[3] *Bread and Butter*, July 31, 1942.

[4] *Loc. cit.*

of agricultural products to allow them to be at 110 percent of "parity"?

At the same time the War Labor Board defined its wage policy as one of not permitting further wage increases except for "adjustments" in the case of such wages as are "out of line" with the general wage level. But if wages which are thus "out of line" are permitted to rise and if, then, the Office of Price Administration permits increases of the prices of goods produced by the workers whose wages have been thus "adjusted," there is a new increase in the average "cost of living." Then there is a new argument for allowing a further increase in the wages first permitted to be raised. And, of course, since the prices so raised are presumably not farm prices, the latter must be permitted a further increase in order that they be not held down to less than 110 percent of "parity." And then further increase in prices of goods made from farm products become "reasonable" and further increase of wages to compensate for the further increase of living costs, and so on.

As this paper is in press there comes news of the President's message to Congress of September 7th, in which he demands legislation authorizing him to fix farm commodity prices at lower levels than 110 per cent of parity and in which he threatens to take action himself under war-time powers if Congress refuses such legislation. But even this demand, although granted, would permit considerable price increases and would leave open the possibility of large and long continued increases of the general price level. For the President states that the "purpose should be to hold farm prices at parity, or at levels of a recent date, whichever is higher." Thus, if any farm products have been at "a recent date" above parity, they would not be forced down to parity; while if, as is the case, some farm products have been selling below parity, these would be permitted to rise to parity. Even with

the proposed new arrangement, therefore, we should have reason to expect further increases in the *average* of farm commodity prices, no matter how effectively the formally set prices were maintained. If, thus, food prices continue to rise *on the average*, are we not still faced with the same problem of the relation of permitted price rises and permitted wage increases above adverted to?

There is a sharp contrast to be noted between the operation of the process of stabilizing the general price level through control of the volume of the circulating medium and attempted stabilization through such price "fixing" as has been described above. If the total volume of the circulating medium is so controlled as substantially to stabilize the volume of spending, individual prices will still fluctuate according to changing conditions of demand and cost of production. With such stabilization, however, all prices will not rise. If some prices rise, others will fall. With the total volume of purchasing power rigidly controlled, any great increase in the demand for and the prices of any one kind of goods would leave less purchasing power for the purchase of other goods. The demand for these other goods must then perforce fall and their prices tend downward.

But if the circulating medium is permitted to increase greatly—as by government borrowing from the banks to meet war expenditures, coupled with extensive private borrowing on the part of defense industries—and the attempt is made to keep prices from rising by fixing price "ceilings," no such balance is likely to be realized. When one price or group of prices is permitted to rise, for such special reasons as have been commented on above, there is not likely to be an offsetting *decrease* of prices of other commodities. Price regulation in war-time is not thought of as a means of forcing price *reductions* nor is it often—if ever—so used. And thus when, as in the policy of the Office of Price Administration,

numerous increases are permitted, the enforcement of corresponding decreases in other lines is not to be expected. Indeed, the enforcement of numerous decreases to offset increases would probably be looked upon as unreasonable and as not a necessary part of the business of controlling "inflation." Such rulings would probably meet with a special resentment. To prohibit an increase beyond—or much beyond—a price that has long been regarded as usual or customary seems reasonable to consumers and may not be too much resented by producers and dealers. To force a price down to a level *below* what has been usual or customary seems less reasonable and is far more likely to stir opposition.

When, with the circulating medium stabilized, the rise of some prices is balanced by a fall of others, because the public demand for the other goods has declined, the fall of prices of these other goods appears as the result of the operation of impersonal forces and not as the personal act of members of a regulatory board. But when the circulating medium is permitted to increase very greatly, so that, unless prices greatly rise, increased demand and higher prices for some goods does not automatically decrease the demand for other goods, an order that these other goods be appreciably reduced in price is likely to look like an unjustified discrimination. And so it is much more likely that any regulatory agency will actually permit an *increase* of prices of these other goods, so that their prices will not be "out of line" with those that have risen, than that they will enforce a decrease.

In regard to the considerations that have been advanced herein, the objection may be raised that increased costs need not be accepted as a justification for increased prices to consumers; but that, if prices to consumers were rigidly held down, dealers and manufacturers simply *could not* meet the higher costs, and so wages, interest, rentals and raw material prices would *have to* stay down. It may well be a fact that

if all retail prices were rigidly and effectively controlled, *if* manufacturers and wholesalers were effectively prevented from disposing of their goods except through these effectively regulated retailers and *if* there were no "adjustments," now here and now there, to sabotage the system, then wholesalers and manufacturers and raw material producers would have to accept low prices and workers would have to accept low wages. The only alternative for wholesalers and manufacturers would be to refuse to sell; and the only alternative for workers would be to cease working—or to produce goods for their own use and nothing else! But obviously, unless such regulation were both rigid and general, it would be utterly ineffective. To regulate retail prices of some goods and not of others in that fashion would divert labor into the manufacture of the goods not regulated. And to regulate retail prices in some localities and not in others in that way would be to prevent goods from going, for sale, into the localities where the regulations applied. Also, confidence would be lacking that prices of goods to retailers would actually be kept down through the operation of the influence of decreased retailer demand. Retailers would be fearful and, probably, resentful of the apparent injustice of the system to them. No one, it seems, seriously proposes any such system and there is little likelihood of its introduction.

Under the war production program, a very large part of industrial activity—including the activity of farmers—is for the production of materials and supplies for the armed forces. These goods do not go through the ordinary retail channels. The government itself, in its various departments, including the military and naval supply services, purchases them, at prices that tend upward as the circulating medium increases. Any attempt to hold down *all* prices, including wholesale and raw material prices and interest, wages and rent, which should depend on regulation *at the retail point,* would be obviously

incomplete if it did not involve also a rigid holding down of all prices paid by the government for all goods purchased by it and for all labor, capital and land directly hired,—unless, of course, the definite attempt were being made, not so much to hold down the whole level of prices, but to *force* men into production for the government and out of production for civilians, by forcing wages and returns generally in the latter to a relatively very low level.

But the same result could be reached much more simply, with probably far less evasion and probably with no greater if as great resentment, by directly drafting labor—and capital and land—for the work needed to carry on the war to a successful conclusion.

We might, indeed, attempt a completely regimented economic society in which scarcely a trace of the voluntary price system remained. We might tell each person what he must do: thus there would be no bidding for his services by producers in different lines or, ultimately, by consumers of different goods. We might ration all goods: in that case, if prices were kept down so that most persons could earn more than enough to buy all they were allowed to buy, few would probably care to earn the added money they were not allowed to spend. But the added work, if needed by government, could nevertheless be had by requiring from each person, in taxes, so much of his income that he would be eager to earn the remainder in order to be able to buy his permitted allowance of the various goods he desired.

The mode of operation of the voluntary price system, the system of free enterprise, is different. Yet through it, if legislators have the courage to use it and are supported by public opinion, they can accomplish most—perhaps not quite all—of what is essential to the waging of successful modern war. If taxes are made so heavy as to take nearly all current income beyond that necessary to maintain efficiency, citizens

cannot bid high enough to induce production of unimportant or unneeded consumers' goods, because the purchasing power left to them will not be enough to permit it. The labor which would have been devoted to making such goods will then be devoted to producing the goods needed by the government for its war purposes.

This is not to endorse such taxation as a long-run peace-time policy. For to take nearly all the earnings of the efficient above enough to purchase current necessities is likely to weaken the desire for efficiency and dissipate the motive for spending long years in training for efficient service. But to take these excess earnings temporarily during a desperate war, when millions of men are required to risk their lives at the fighting front, is not so likely to have this unhappy consequence and may be necessary in order that the earnings of this very efficiency may be secure in the ensuing years. Believing as I do, that the common welfare is best promoted if we use for public needs the geologically-produced and community-produced annual rent of land before drawing on incomes earned by labor and thrift, I nevertheless realize that in "total war" the earnings of labor and thrift should also be drawn upon for nearly all they will yield.

If we adopt such a policy at the moment when war begins, the demand for non-essential consumers' goods inevitably suffers a sharp decline. Few can longer make a living producing such goods. All who would work for a living and are not in the armed forces will eagerly seek jobs making guns, tanks, bombers, aircraft carriers, transport ships and planes, helmets, uniforms and the other things that must be made in quantity and at the fastest rate possible.

Because circumstances and essential expenditures differ in different districts and among different persons in ways no uniform tax system can take adequate account of, and because of the delays and discrepancies almost inevitable in

introducing new tax legislation and in arranging for the necessary administrative set-up, other measures may indeed be desirable. The requirement, for example, that automobile companies cease immediately their manufacture of passenger cars, in order that their plants may be turned at once to war work, may be most important. Even if legislative and administrative delays in revamping the tax system could possibly be avoided, manufacturers might still *hope* for more sales than actually could be realized and so might postpone the complete transformation of plant that the circumstances desperately require. For similar reasons, a priorities system and some rationing may be desirable. That the few remaining cars, when automobile manufacture ceases, should be reserved for doctors, defense workers and the like, rather than that they should go to the highest bidders regardless of national needs, certainly seems altogether reasonable. But if large incomes are left for private expenditure, these incomes may be spent in other ways and for other non-essential goods and so with little less retardation of the war effort.

Finally, as regards price regulation, the comments herein on the evasions of it and on the compromises and "adjustments" which so largely characterize it in practice, need not lead to the conclusion that absolutely no good purposes are ever accomplished by it. Conceivably, for example, the outbreak of war, by arousing the anticipation of increased prices of certain commodities—e.g., sugar—in the minds of consumers and of manufacturers and dealers, might conduce to widespread buying for hoarding by consumers and to speculative buying and holding by dealers, thus bringing about sharp increases in price. Under such circumstances both price limitation and rationing might be advantageous. Yet we must remember that the speculative and the excess consumer buying against which such measures are taken may be in large part, the result of anticipation of a rise of price

which is itself caused by war-time government borrowing from banks and the consequent increase of the circulating medium.

In ordinary times speculation in commodities performs, often, a social function. For example, there is the purchase of wheat by speculators in the early fall, when it is plentiful, to be sold out gradually during the year. Also, eggs are bought in the spring when hens usually lay most plentifully, and kept in cold storage for sale in other seasons when they are scarcer and, except for such holding, would be much more expensive. And so with various other commodities. But it may be contended that speculative hoarding in war-time is likely to increase greatly the price of necessities to the many whose incomes are relatively small, that excess buying and hoarding by some consumers, inspired by the panic fear of scarcity, tends still further in the same direction, and that price regulation coupled with rationing has definite advantages.

In any case it remains true that price regulation is often subject to considerable evasion; that it is full of difficulties; that, for example, if the prices of some goods are held down a little too much in relation to the prices of others, the production of the too-strictly regulated goods may be disturbingly decreased; and that those whose duty it is to administer the price-fixing legislation seem driven to make compromising adjustments through which average prices rise greatly even aside from "black market" evasions.

Subsidies and War-Time Price Control

About a year ago I published a paper, "Fiscal Policy and War-time Price Control," in this Journal,[1] dealing with the problem of war-time inflation and the attempt to hold prices down by administrative decree. Emphasis was placed on the difficulties of preventing price and wage increases while, simultaneously, increasing greatly the circulating medium. If Congress would levy taxes heavy enough to pay for the war—or nearly pay for it—from current tax revenue, such taxes would take spending power away from individuals in proportion as they increased the spending power of the government. Excess money that would otherwise be used in bidding for goods and so promoting price increases would thereby be absorbed for government war-time use. Inflation of the circulating medium would be unnecessary. And to follow this policy would be quite consistent on the financial side with the use of the principle of selective service on the military side. Everyone would be required to contribute what he could. Just as the young man able to meet the physical requirements for military service has been asked to sacrifice his liberty and well-being and to risk his health and his life, those at home with surplus spending power would at least be asked to pay in taxes substantially their entire surplus over reasonable necessary living expenses.

Because taxes have not been anything like as high as they might have been and because tax contributions plus purchases of government bonds from *savings*, taken together, have been inadequate, the government has felt obliged to borrow billions of dollars from banks. *It is this borrowing of new and additional circulating medium* from banks, and

[1] Am. Jour. Econ. Socio., 2 (Oct. 1942), 1–14.

its distribution in paying for goods and for labor, that forms the basis for the current inflation. To attempt to hold down prices, wages and rents under such conditions is like trying to hold back a car by pressing down the brakes, while simultaneously pressing down the gas pedal! Thereby come such various evasions, compromising adjustments by the price-fixing and wage-fixing authorities, quality and label changes and black markets as were described in my paper mentioned above.

But when these inevitable effects of our fiscal policy occurred, the contention was advanced that these difficulties could be avoided by means of subsidies. According to this plan producers receive payments from the government to cover, in part, their costs of production. In consideration of such payments they are supposed to keep down—or even reduce—their prices. The idea seems to be that the rise in the cost of living must be stopped, but not by doing away with its cause, *viz.*, the increase in the circulating medium brought about through borrowing from banks!

From what source are such subsidies paid? The thought of the advocates of this plan appears to be that they will be paid out of increased taxes. That they will actually be so paid does not seem very likely in view of the history of our tax policy in this war. Nevertheless, let us suppose that funds for such subsidies are so raised. How far, then, do we really relieve ourselves from the evils of rising prices by thus paying less in formal purchase prices for goods when at the same time we pay correspondingly more in taxes so as to reimburse the very people from whom we purchase the goods!

It is argued by some, indeed, that the tax method has the advantage of making persons with larger incomes help pay the food and clothing bills of persons with smaller incomes. But if, because government finances this war so largely by

borrowing from banks, prices tend progressively upward and we are then urged to impose heavier taxes on the recipients of the larger incomes to protect others—by means of subsidies to producers—from the rising prices, why not instead impose these higher taxes *to meet war expenses?* Thereby we would avoid borrowing from banks and would bring an end to the progressive increase of the circulating medium from which the trouble stems. Is it not ridiculous that we should levy high taxes to get money to pay subsidies in order to secure funds to appear to hold down prices, when the prices are rising just because we *won't* levy high taxes to pay war expenses? Because we insist on paying a large part of these expenses by means of borrowing from banks?

It should be noted, however, that many advocates of subsidies do not wish to have the subsidies paid to all of the producers in a given subsidized line. Instead, they would have subsidies paid only to the "high-cost" producers, assuming that other producers can, and should be compelled to, keep prices down without such help. But in fact, as competent economists know, the question of what is the most expensive part (the "high-cost" part) of the supply of any commodity is much less simple than this. A very considerable proportion of the most expensive part of the supply of any commodity may come from producers who are, on the average of all their production, in the "low-cost" groups. A slightly lower price, therefore, might cause even such a low-cost producing corporation or individual to produce *less* of the commodity than before,—*e.g.*, to stop producing wheat from one of the poorer fields *or* from a field pretty well adapted to another crop, or to stop producing coal from one of the company's poorer veins. Or the lower price of the commodity might mean less demand for labor in that line and lower wages to employees, with the result that *some* of

these employees would decide to leave the particular line of work for some other line.

Should subsidies be paid, then, not to "high-cost" producers only but to "low-cost" producers also, at least on part of their output; and, if so, on how much of their output should the subsidies be paid? Should subsidies be paid to workers who, because of their alternatives, may be unwilling to remain in an industry for a wage which many other workers are willing to accept? For, certainly, the product of such unwilling workers is a "high-cost" product. Or shall subsidies be paid to capitalists and land owners but never to wage earners? Should subsidies be paid to all of those who are relatively inefficient in a given industry, so as to keep them in it,—on the theory that their part of the supply is a "high-cost" part? And then, if the subsidies in one industry make it seem relatively profitable, shall subsidies be paid to other industries to keep men from leaving them to go into the originally subsidized ones? How widely, indeed, shall this government favor be spread?

The cost of production of any commodity, in the sense of what must be paid to get the commodity produced, depends on what those engaged in producing it—or who might be induced to produce it—believe they can get in other lines. Cost of production is, therefore, relative. If inflation causes some prices to rise rapidly while other prices are held down, many of those in the regulated lines are likely to leave those lines *unless* prices and incomes are allowed to rise in their lines also. And in like manner subsidies in *some* lines, which are not granted in other lines, definitely tend to draw labor and capital and land away from such other lines. Where, then, shall subsidies stop? And, if they are not given to every one, who shall select the favored individuals and companies to which the payments shall be made, and on what basis and by what detailed research shall the selections be made?

But indeed, since we are not now meeting the exı carrying on the war out of taxes (or, even, out of ta voluntary savings invested in savings bonds) but are l ing very largely from the banks and thereby ex greatly our circulating medium, *why* is it so glibly that the subsidies will be paid for out of taxes? these subsidies are in fact paid for with funds borrow the banks? What if this means *even more* borrowiı the banks by the Federal government than we have h erto and, consequently, an *even vaster* increase in pu power! Would such a result not resemble, in some fashion, trying to hold back a car by pressing down tl (price regulation and rationing) while simultaneoı only putting on a full head of gas (borrowing for tl ing of regular war expenses) but also getting the caı from behind (more borrowing—to pay for subsic another car or a truck?

To date, in carrying on World War II, we have vented prices from rising in considerable degree. above considerations apply, how can we conclude t sidies are the real solution? How can we maintain we now pay subsidies, prices will rise no further b instead, we shall successfully "roll back" the pri improve the economic status of the relatively poor a discontent?

TO THE EDITOR OF THE —:

On Friday, November 5th, you printed beneath the daily cartoon an editorial on subsidies from the New York Post, in which it was stated that if the government is prevented from paying 70 million dollars in subsidies "to keep the price of bread where it is now", all of us "will have to pay 350 million dollars more for our bread" and that this also "means pork up more than 13 cents a pound" and "all other meats in proportion."

In the President's November 1st message to Congress he is quoted as saying that, in the case of copper "it has been estimated that every dollar paid by the government to subsidize and increase production has saved the government $28."

Now comes your editorial of Friday, November 19th entitled "All of Us Must Face It", in which you refer to those members of Congress who oppose subsidies as "stubborn, unreasonable, unpatriotic men."

Suppose, Mr. Editor, that you had been in Germany in the very early 1920s when paper money was being printed in vast amounts and prices were rapidly rising. Suppose it had then been proposed to hold down these prices by paying subsidies to producers. Suppose that, knowing the government was constantly spending more than it was taking in through taxation, you recognized that payment of the proposed subsidies would actually be made only through the printing and issuing of even more billions of paper money. WOULD YOU HAVE EXPECTED THIS TO BRING PRICES DOWN?

Right now we in the United States are paying for the war more by borrowing than by taxation and a large part of the borrowing is from banks. Since 1939 bank credit has, through government borrowing, expanded a very great deal. The more and the larger subsidies the government pays, the more it will borrow from the banks. And this increased bank borrowing is equally inflationary whether it takes the form of Federal Reserve notes (paper money)

or increased bank balances on which the recipients of subsidies can write checks.

Do the members of the editorial staff of the — really believe that for each additional dollar of Federal Reserve notes (or other form of bank credit) borrowed by the government and paid out as subsidies, prices of goods will be lowered by from 5 to 28 dollars? Doesn't that look like magic? The view presented in the passages quoted above seems now to be regarded as the "liberal" view, — but it doesn't make sense. —

November 20th, 1943 Very truly yours,

III

The Danger in the Mounting National Debt

COMPETENT ECONOMISTS in the field of public finance understand that a nation at war cannot impose the burden of its war on posterity through borrowing from its own people. If the debt is paid by the next generation it is also paid to the next generation. When the bondholders of this generation are dead and so can no longer pay taxes for the repaying of the bonds, they obviously cannot receive the money paid by government to the owners of the bonds.

If, as we carry on war, we of this generation are made to pay for it in taxes, we realize and admit that it is we who are doing the paying and sacrificing. But to those who have not analyzed the phenomenon, it often looks as if, when we lend to the government, the case is fundamentally different. In truth, if we purchase (say) savings bonds from (i.e., lend to) the government for war purposes, we *give up having* the goods we might instead have purchased with the money. Just as if the money were taken from us by taxation, the government spends what we might have spent but now cannot or do not spend. Labor is devoted to producing war materials instead of goods for civilian enjoyment. And, collectively, we do not just defer this spending. We resign it forever. For, collectively, we can never get back, for spending, the money so loaned to the government *except as we pay ourselves back*. My taxes may possibly be used to pay you or your tax contributions may pay me but, counting us all, we repay ourselves. Or else, as said above, if repayment is delayed until this generation has gone, so that the taxes for

repayment are drawn from the next generation, then the money paid out in redeeming the bonds (repaying the loan) is paid to the next generation.

The fact that the next generation does not repay this generation but pays itself does not mean that our war imposes no loss on our descendants. Capital has been destroyed when it might have been conserved. Repairs of many kinds of capital have been made impossible. The accumulation of new capital for civilian purposes has been prevented by the needs of army and navy. Instead of capital construction we have had to give ourselves to destruction not only of the products of the labor of the enemy but also of the products of our own labor, e.g., explosives. And so the next generation will find itself less well equipped with capital than it might have been and not able, therefore, to produce goods so effectively. In various other ways, too, progress has been checked and the efficiency of production decreased. But at least the next generation definitely does not lose still further by having to *repay* advances made by this generation.

The Public Debt and the Taxing Power

THE FACT, HOWEVER, that a domestic debt owed by government is, socially speaking, not a debt, has seemingly misled not a few persons into the mistaken view that it is, therefore, not a matter to worry about, regardless of how large it may become. Thus, some of the enthusiasts for government spending in the later thirties and the pre-war forties—and since Pearl Harbor, too—have rather insistently argued that the size of our mounting debt need not be a matter for alarm. What on the side of taxes is outgo, they have contended, is, on another side (the side of the holders of bonds, as such) income. Unless our taxes to pay the bondholders are unduly

heavy on the very poor who have not the means to pay, we need not worry at all. What if our taxes are sky high, even, provided they are levied just to pay income to ourselves? And although sometimes John Doe may have to pay very heavy taxes in order that Richard Roe may receive interest on his bonds, what of it so long as John Doe can afford to pay these taxes? If he cannot afford to pay them, we have merely to tax Paxton Poe or Mortimer Moe!

In short, to our "liberals" of (sometimes) collectivist bent, especially if they have dreams of using the taxing power so as to take from some and give to others in the proportions they approve, a domestic debt is, often—or so it appears—no disadvantage whatever.

But although the interest on the debt—and the principal, too—is indeed paid by ourselves to ourselves and although it may seem possible to arrange the distribution of income, by means of taxes, so as to take from and give to whomever we want to, such a debt may still be a very great evil. For in a society in which the production of wealth depends upon the motive of individual reward, the taxes necessary to service such a debt may have serious consequences on productive efficiency.

How shall the debt be paid? Shall it be paid by heavy taxes on capital? But surely a national debt can be so large that the taxes on capital or on the income from capital necessary to pay it—or, even, to service it—might discourage saving and investment and thus gradually decrease the capital equipment which labor must use.

Consider the case of a person who saves and invests $10,000 which yields, before taxes, $700 a year (7 per cent). But taxes take, we may suppose, such a large part of this that he

has left only (say) $50 or $75 a year. Whether or not he holds any part of the national debt in the form of government bonds and so receives interest payments on this debt from the aggregate of moneys collected in taxes, in any case he has to face the fact that from his new savings of $10,000 he will receive less than one per cent instead of seven per cent. It is to be noted, too, that whatever the remaining gain which may be hoped for *on the average,* whether less than one per cent or one and a half per cent or two and a fourth per cent, some investors in capital actually lose, i.e., receive less than zero per cent. If, now, most of the gain from *successful* investment of savings is absorbed by government through (say) highly progressive income taxes piled on top of local property taxes, the would-be saver and investor may decide that his risk of loss is not sufficiently offset by the reasonably likely gains to make the saving and investing worth while. (What, indeed, if the taxes become so high as to make the *average* gain from such investing, for many persons, *less than nothing!*) He may, then, either not save at all or simply hoard money—or silver, platinum or diamonds—rather than aid in the construction of productive capital.

The fact that, taking us collectively, the money drawn from us in taxes to pay interest on a gargantuan national debt is in turn paid *to* us as interest on the bonds we hold personally, is irrelevant to the present problem. For the particular individual who saves, and invests in new capital, will be taxed on this new capital (or the income from it or both) equally whether he does or does not own any of the government bonds. And he will receive interest on his bonds regardless whether he does or does not accumulate new capital. If, therefore, his chance of gain from such new capital is greatly reduced by heavy taxes levied to pay interest on the govern-

ment debt, or to pay off the principal, there seems a reasonable likelihood that he, and others in like case, will save less. When this occurs, the community will have less capital.

Mortgaging the Masses to the Classes

WHAT, NOW, IF THE TAXES to service the debt are levied on articles of common use so that a large part of the burden of the levies falls on the poorest classes of citizens? And what if, as may well be the case, the bonds are owned largely by the well-to-do and by persons of moderate income? Then we have a situation in which the poor are heavily taxed to make possible interest payments to the comparatively prosperous. This has been called "a mortgage of the masses to the classes" and there are some who have rather questioned its desirability.

Or, what if taxes on income from work become so highly progressive as to remove, largely, the motive for acquiring or showing superior efficiency!

It is true that a good deal of revenue could be collected by a tax on the annual rental value of land (whether this could be provided for without constitutional change is not here being considered) and that such a tax neither takes anything from the wages of the poor nor puts any penalty or discouragement on saving and capital construction. But none of the apologists for large government debt, so far as I know, has ever urged this non-repressive tax as a means of paying it off. By implication, we must apparently suppose, they expect such a debt to be serviced—and paid, if ever—by the ordinary sort of burdensome and repressive taxes.

Even, however, if such a debt could be and were to be serviced and paid off wholly through a land-value tax, there still would be the consideration that this would compel reliance on other and repressive taxes for the ordinary expenses of government. With no large debt to be serviced, it should

be possible to meet, from the public appropriation of the geologically- and community-produced annual rental value of land a very large proportion, at least, of current governmental expenses. But without greater understanding than is at present found among legislators and publicists, this vast annual fund is not likely to be greatly drawn upon either for the ordinary expenses of government or for paying the national debt.

If a government debt becomes so great that the payment of the annual interest on it makes taxation seem unbearably heavy, legislators may lack the courage—or the rashness?—to levy the taxes required for paying both the interest on the debt and the current expenses of government. Instead, they may resort to payment of part of the heavy total of expenses by increasing the currency. Such currency increase may be entered upon with no very acute consciousness of its effect in raising prices; or, at least, no open admission that this will be the effect. But if the currency increase is substantial, prices will rise greatly, incomes (measured in dollars) will also increase, and the burden of the debt on taxpayers will thus become less.

If government acts wisely in other ways, then it should endeavor to maintain a stable general price level (average of prices). But what if government follows a policy that imposes on taxpayers a tremendously burdensome public debt? What if, too, it establishes minimum wage standards above those that can be met at the prevailing price levels except at the cost of widespread unemployment? And what if, also, it becomes committed—as by state constitutional provisions, so that formal reversal of policy is politically well-nigh impossible—to heavier contributions for old-age pensions, mother's pensions, etc., than can easily be borne by the tax system without danger of political and social upheaval, at any

rate when there is a big debt to be serviced? May it not then appear that payment of all the obligations thus assumed, out of new issues of paper money, with a resulting rise of prices and, therefore, with a substantial reduction of the *real* burden, is the only politically practicable way out of the impasse?

To maintain a stable general average of prices, i.e., to see to it that the dollar has the same value or purchasing power from year to year just as we see to it that the yard has the same length from year to year, has been referred to above as a desirable objective of public policy. And this can be done—at any rate much more nearly than it has been done hitherto—by a wise control of the volume of circulating medium.

Crisis Policy and the Public Debt

BUT HERE, WHERE we are concerned especially with the problem of burdensome public debt, I want to emphasize the point that such control of the price level need not depend on or in any way utilize for its accomplishment, an increase in the public debt and a corresponding increase in the burden on taxpayers to service the debt. More specifically, in the operation of the New Deal monetary policies during the depression of the nineteen thirties, there was never a time when it was necessary to increase the interest-bearing debt of the Federal government either to increase the circulating medium or to decrease it. Nevertheless, the debt was increased greatly. In consequence, when we entered World War II we already had a pretty heavy national indebtedness.

One of the ideas of the New Deal in its early days was to promote recovery by having the government borrow and then spend what it borrowed, hiring labor (e.g., through the W.P.A.) and engaging in various kinds of production. In so far as this borrowing was from private persons (selling government bonds to them), the borrowing and spending was of doubtful utility. If Smith has $100 with which he would

have purchased an electric refrigerator or a radio receiving set, or would have hired someone to help him build a new garage, and instead he is induced to buy a government bond and the government then spends the $100 in W.P.A. work or otherwise, it cannot be said that there has been an increase in demand for goods or labor. For the government is merely spending what Smith would have spent and giving effect to no more demand for labor than Smith would have given had he not loaned the $100 to the government. Unless the $100 thus taken over and spent by government merely would have been *hoarded* by Smith, the spending of it by government has no demonstrable net stimulating effect.

If, however, the government borrows from *banks* and *if* the banks, having large reserves, thus lend to the government *without lending any less to private business and to individuals,* then there is a clear and definite increase in circulating medium and in total spending.

But this method of increasing the circulating medium is objectionable even to stimulate revival from depression. For it involves increase of the government's interest-bearing debt and the beneficial results desired can be obtained equally well in another way. The earlier paragraphs of this paper have been directed to showing that a large government debt is not a matter to be looked upon with equanimity but may be, instead, an economic calamity. And if it is desired, for any reason, to gain an increase in circulating medium, for example, to counteract an immediately preceding credit restriction that has brought depression in its train, and to promote revival, this can be easily done *without* the government's borrowing from banks. A new and additional issue of paper money, e.g., greenbacks, can be used directly for the desired government spending; or this new money can be put into the banks as a government deposit on which the government can draw checks.

"Oh, but that is inflation," it will be said. As a matter of fact, however, it is no more inflation for the government to issue—and spend—$1,000,000,000 of new paper money than for it to borrow from the banks so as to increase bank deposits by $1,000,000,000 and then spend this $1,000,000,000 by writing checks on it. The increase of circulating medium is no greater in the one case than in the other. For bank deposits subject to check are circulating medium. And the increase of government spending is no greater in the one case than in the other.

"But," it will be said, "we cannot trust our government to issue new paper money lest it issue such money in excess." To which I would say: "Can we, then, trust our government to borrow from the banks, since this, too, may be done in excess and, if so done, is also inflationary?"

The fact is that to avoid the evils of periodic severe depressions and to maintain a reasonably stable level of prices, we must have, somewhere, effective control of the volume of circulating medium. If we cannot hope to trust our government or to have, ever, a government that can be trusted to do this (and, therefore, a public opinion that will consistently allow such a policy) we may well despair of the future of the system of free enterprise.

The Strategy of the U. S. Gold Policy

NOT ONLY DID the New Deal use government borrowing to increase the circulating medium and promote business revival. It used the same device to *hold down* the circulating medium and prevent prices from rising. One is reminded here of the man in Aesop's Fables who blew hot and cold with the same breath (both warming his hands and cooling his porridge by blowing on them). In brief, this story of New Deal policy is as follows:

In the early months of the New Deal we ceased coining

gold but fixed its price at $35 per ounce, the value of gold having previously been $20.67 in American money. The government undertook to buy at this price of $35 per ounce all the gold offered and, indeed, required all producers of gold bullion in the United States and all importers of gold from abroad to sell their gold to the Treasury. Individuals or companies needing gold for manufacturing purposes, and banks or others needing gold for export, could buy it from the Treasury (after securing a license from the Secretary) for $35 an ounce. Such a new and higher price for gold naturally stimulated the purchase of American goods with gold, and billions of dollars worth of gold came into the United States. This gold was paid for by the Treasury with gold certificates to the Federal Reserve banks, thus increasing their reserves (these gold certificates being legal tender but in very large denominations and not, in practice, used for general circulation). The other banks, national and state, whose customers were exporting to foreign countries the goods for which the gold was being exchanged, got increased balances with the Federal Reserve banks (i.e., increased reserves) and, thus, increased lending power. And the exporting customers had, of course, the increased bank balances (or cash) consequent on their foreign sales. In short, although the gold itself was no longer money within the United States and did not circulate as money, the effect of the purchase of gold at the new and higher price of $35 an ounce was to increase the circulating medium.

In 1933–1936 this increase of circulating medium was a favorable condition for revival from depression, since it promoted increased spending and increased demand for goods at a time when there was idle labor and idle capital which could be employed in meeting the increased demand. Even so, the increase of circulating medium could have been brought

about otherwise than by means of the purchase of billions of dollars worth of gold from abroad. Also, it is to be noted that business revival might have come faster except for the contemporary policy of the government, under the N.R.A. and A.A.A., of encouraging semi-monopolistic price increases of manufactured goods, thus tending to keep down demand for them despite the increase of circulating medium, and of endeavoring to decrease output on the farms and so decreasing employment on the farms for tenants and laborers.

But in due time it began to appear that the constant purchase of gold and the paying out of increased circulating medium for the gold, might bring a considerable and an undesired rise in the price level and steps were taken to prevent such a result.

Such a step might have been to cease purchasing gold or, at least, to cease purchasing it at the price of $35 an ounce. A *sufficient* reduction in the price offered for gold would certainly have prevented the gold from coming and so would have ended the payments of billions of dollars of new purchasing power calculated to push prices upward. But the price offered for gold was *not* lowered. The recently adopted price of $35 an ounce semed to have become a kind of *sacred* price, not subject to change, or else it was feared that particular interests, politically powerful, would oppose a reduction in the price of gold lest this reduce slightly the price in dollars they received for goods sold abroad. Nevertheless, it is not advantageous to us, as a nation, to send abroad billions of dollars worth of American goods for which we receive no useful and to-be-used goods in return but only gold to be deposited in a vault at Fort Knox, Kentucky, and kept there indefinitely.

The American Penchant for Borrowing

RATHER THAN LOWER the official price of gold, the Treasury endeavored to *offset* the inflationary effect of the inflowing

gold by selling government bonds and by withdrawing from circulation the money—and bank deposit accounts—paid in for them. The purchasers of the bonds, of course, thereby had their available means for purchasing goods reduced. And the checks on the various banks in payment for these bonds, collected by the Treasury through the Federal Reserve banks, reduced the reserves and potential lending power of the banks on which the checks were written. Thus, the effect of the Treasury's purchase of gold tended to be precisely neutralized by its sale of government bonds. This process was referred to as one of "sterilizing" the incoming gold!

In effect, the government paid for the incoming gold—for which it still insisted on paying $35 per ounce—by selling its bonds, i.e., by borrowing at interest. Although any danger of inflationary rise of prices could easily have been met without our assuming an increased interest-bearing debt, that method was chosen. The Treasury could have lowered the price at which it would buy gold. If necessary to sell something, the government might have sold some of its useless hoard of gold or silver or both and retired from circulation the money (or bank deposit accounts) paid in therefor. But none of these policies was chosen.

Borrowing has been a policy followed by the New Deal both to promote business revival and to halt inflation. We have just seen that borrowing (i.e., selling its bonds) by the government may decrease circulating medium and bring lower prices if the government does not spend but withdraws from circulation the money (or bank deposits) it receives; and especially if, at the same time, the banks do not have large reserves and, therefore, have to hold down or reduce their loans to business when collection from them of the checks paid in for the bonds reduces their reserves. Earlier in our analysis we noted that government borrowing might increase

the circulating medium, so promoting revival if business is dull but, of course, bringing rise of prices if business is active. But such effects are dependent on the borrowing being from the banks. And they depend on the banks having excess reserves so that they can and do lend more to the government without lending correspondingly less to business. Also, they depend on the spending by the government—and not withdrawing from circulation—of the money or check credits received for the bonds.

One might, indeed, attempt to account for the debt-increasing proclivities of the New Deal on the basis that no other policies were, at the time, politically possible! But perhaps these proclivities are in some degree the consequence of an easy-going acceptance, by New Deal economic advisers, of the notion that a national debt of any size is nothing to worry about if and because we owe it only to ourselves! Conceivably herein is an important reason why the present World War is being financed by the United States so largely through borrowing and so little by means of taxation! And conceivably it will turn out, eventually, that currency inflation is the only practicable escape!

Our citizens have been urged to buy war savings bonds not alone on grounds of patriotism but by claims that they are a good and sound investment. If all funds not thus raised from savings and the voluntary subscriptions of citizens were raised by taxation and if bank deposits subject to check and other circulating medium were *not increased* through government borrowing, then inflationary price rises might be—or might have been—avoided. But in so far as inflation reduces the purchasing power of the money later paid to the owners of savings bonds, it must be admitted that the qualities of the bonds as an investment have been misrepresented to them. Or shall we later make the bonds worth more in

purchasing power by having a *deflation* with accompanying depression and unemployment? If, instead, the burden of the debt finally becomes so great as to drive us to still further inflation as the only practicable escape from formal repudiation, what shall then be said of the good faith with which the government has urged citizens to purchase the bonds?

Alas! What looks to the popular and superficial view like the easiest path for a nation, may finally become for the great majority—though a few be able to profit from the general distress—the hardest of all. But how shall legislators and administrators be sufficiently persuaded of this before it is too late?

IV

Policies for Full Post-War Employment

THE QUESTION IS sometimes asked: "If we can have prosperity when there is a war on, why can we not have prosperity during the years of peace?" And yet, at the same time, there appears to be a widespread idea that war must be followed by business depression or, at least, that to prevent such an aftermath, there must be careful and detailed "planning" for after-war production and jobs.

No solution of this problem is possible without a careful analysis of the forces that tend to prosperity and to depression. In such analysis it will appear that especial attention must be devoted to monetary influences or, more broadly, to the effects which may be produced on prices and on business activity by fluctuations in money and in the checking accounts of commercial banks. And it may appear that without intelligent monetary policy no amount of "planning," whether by government administrators or business "leaders," can save us from recurring depressions.

An increase of spending means an increased demand for goods and for labor. This is what we have had during World War II and what we had in World War I. Indeed, we seem to have it in every war.

In war time a much larger proportion of the spending than at other times is by government. But there does not appear to be the slightest reason to believe that $1,000 spent for goods or for labor by government will have any greater stimulating effect than $1,000 similarly spent by private corporations or by individuals. If the spending of money is what we need for prosperity, it would seem that we ought to

be able to do as well with individual spending as with government spending.

The total volume of spending during any period, such as a year, depends on *how much* circulating medium there is to spend and on the *rapidity* with which it is spent, i.e., on its "velocity" of circulation.

A given number of dollars would make possible a much greater amount of total spending if only each person would *immediately* spend for goods, for labor or for the use of land or capital the money he receives in his own business or for his own work. But hardly anybody wants to spend instantly all the money he receives. He prefers, rather, to have some on hand for emergencies. Household gadgets that are now, apparently, all right, may break or unexpectedly wear out and need to be replaced. Clothes may become badly torn. There may be unexpected occasion to go to a distant city by airplane, bus or train. Exceptionally good shows may come to town before the next salary check is received. And even apart from such considerations as these, the average person likes to have time to decide at his leisure between the various things for which he may spend his money. He likes to have time to "shop around."

It is not desirable that people should be put under great pressure to spend their money more rapidly than their own convenience dictates. For such pressure would appreciably limit their freedom of choice in the purchase of goods and services and in investment. But when, because of monetary inflation, prices are rising rapidly, there is such pressure. Recipients of money, whether as wages or otherwise, feel obliged to spend it at the earliest possible moment, even though they have not the time to decide carefully and wisely for what to spend it, because the money will buy so much less if it is kept for some time unspent.

But if, on the other hand, prices in general are falling at a noticeable rate and further decline is expected, there will be some tendency for recipients of money to delay purchases, because of their anticipation that their money will purchase more at a later date than at or near the date of receiving it. Likewise a merchant, if he anticipates either declining prices or generally dull business, will be more likely to hold his money or bank deposit account unused for a relatively long period than if his anticipation were otherwise. And a manufacturer will be more hesitant to spend current funds buying raw material and hiring labor if he believes *either* that the prices of finished goods will greatly decline *or* that he is likely to find difficulty in selling them. These two contingencies come to the same thing. For there is almost always *some* price at which goods can be sold; and to say that they may have to be sold at a low price amounts to saying that they may not be salable at all at a higher price.

Despite the possible importance of velocity of circulation as a *derivative* factor, I believe we shall do well not to assume that it has any especial importance in initiating either rising prices or falling prices. And I believe we ought not to expect to find in velocity of circulation of money and bank credit an important influence in the initiation of business depression.

The greater velocity with which money is spent when prices are rising is, as has been indicated above, a *consequence* of the fact that the money will buy less—or is expected to buy less—if spending is deferred. It is true that this increased velocity of spending still further increases the demand for goods and tends to accentuate the rapidity with which the prices of goods and services are rising. But unless some other cause—presumably an increase of the *volume* of circulating medium—gives the initial push to prices, it is alto-

gether unlikely that the increase of velocity of circulation will occur at all.

And likewise when prices fall and velocity declines. The decrease of the velocity of spending of money does not come arbitrarily. It is *because of* the expectation of falling prices —or of unsalableness of goods *except* at lower prices—that men spend their money more reluctantly, i.e., at a slower rate. And we cannot reasonably assume this expectation to be self-causing or to be the consequence of dire predictions made without basis in existing economic fact and yet so widely believed as to bring about a fall in prices that would not otherwise have occurred! On the contrary, it is much more likely that any great decrease in velocity of spending will manifest itself only when and as some other influence—presumably a decrease of circulating medium which might be brought about through restriction of commercial bank credit —decreases the demand for goods and makes prices tend downward.

This does not mean, of course, that velocity of circulation may not change for other reasons. As specialization increases, as more people—or less—live in cities, as credit institutions develop, as habits of other kinds change, the velocity of circulation of money may gradually change, entirely apart from the influence of rising and falling prices. But that such changes would be rapid enough to make the general price level rise or fall greatly and quickly does not seem very likely.

When, therefore, the demand for goods in general increases or decreases, the initiatory influence would appear to be an increase or a decrease of the total volume of circulating medium. The question may still arise, of course, why the volume of circulating medium changes. But, in most countries, this is either directly controlled or is obviously subject

to control by government. Velocity of circulation, on the other hand, is a matter of individual choice. Government can influence it only by giving its citizens a motive to spend money more or less rapidly. In general, government influences velocity of circulation only as it determines the volume of money and so causes prices, on the average, to rise or fall.

II

WHAT, THEN, IS the reason for war prosperity and why can we not have as great prosperity continuously?

We do have very active business—"prosperity"—at times when we are not at war. The year 1919 was a year of very active business. The year 1926 has been regarded as a year of high prosperity. And so of various years and periods of years. Yet there are recurring depressions and some of them are severe and protracted. What is the explanation?

There have been many and complicated explanations of the alternation of prosperity and depression. But the one fundamental influence—the influence that must be especially emphasized in any explanation that is even approximately correct—is to be found in changes in the volume of circulating medium.

In general, increase of circulating medium (money, and bank deposits subject to check) tends to increase prices. Here we are using the word "prices" in a broad sense, in which it includes rentals and wages. But if business is dull, an increase of circulating medium may show its effect partly in stimulus of business activity. When more is being spent, there must obviously be *either* more transactions (more goods sold, labor hired, etc.) *or*, if there are no more transactions, the fact of more being spent can mean only that prices (including wages and rentals) are higher. When there is full

employment and the annual output of goods cannot be appreciably increased, any greatly increased volume of circulating medium and correspondingly increased spending *must bid up prices.* But an increase of spending when there is *not* full employment may aid in putting the unemployed to work. May it not be that the business activity of war-time is to be explained in terms of greater spending and, mostly, in terms of their being *a larger volume of circulating medium to spend?*

An increase of spending promotes business activity *because* prices, including wages, rentals, etc., do not ordinarily increase as rapidly as spending increases. If, with the volume of circulating medium doubled and the number of dollars annually spent also doubled, prices, including wages, rentals and other payments, instantly doubled, the doubled spending would then be barely sufficient to take care of the same total of transactions. There would be required, for example, a doubled spending for wages to employ the same number of workers as before. Such increased spending could then have no stimulating effect on business activity or on employment. If the consequent rise of prices and possible anticipation of still further rise stimulated a still greater spending, nevertheless even this still greater spending could have no stimulating effect on business and employment if prices, including wages, etc., instantly increased again in like proportion.

Are we not likely to find war-time a period when spending is greatly increased and when, though wages, rentals and prices in general rise, nevertheless this rise *fails to keep pace with the increase of spending?* Indeed, is it not a fact that during war there is often or usually an effort to hold down prices, including rentals and even wages, by administrative regulation, to a lower level than they would almost certainly

reach if the greatly increased spending were allowed to reach its full unregulated effect? Under such circumstances, it could scarcely be anticipated that business would be dull. High activity is by all means to be expected.

Whence come the means for increased war-time spending? Government takes the initiative. The increase of demand for goods and services, the increased demand for labor, come first from government. And this increase of demand from government becomes effective on business activity and on prices through an increase of circulating medium. Many times this has meant a large issue by government of paper money. The Continental currency of the American Revolutionary War and the Greenbacks issued by the Union in the Civil War are familiar examples.

But at other times, and more especially in the twentieth century, the increase of circulating medium has been chiefly in the form of bank deposits subject to check and has resulted mainly because of government borrowing from banks.

In this connection we must note that the borrowing which tends particularly to increase demand is borrowing from banks. If government borrows from an individual, his means of purchasing goods or labor are reduced by the amount he lends to his government. The government has more to spend. The citizen in his individual capacity has less to spend. *Unless* the money borrowed from the citizen *would have been hoarded* longer by him than by the government, there is here no increase of spending at all, no special stimulus to business activity and no tendency to bid up the general average of prices.

But *if* the government borrows from the banks and *if* the banks, having sufficiently large reserves, thus *lend more* to government without correspondingly reducing their loans to individuals, then there is a clear and definite increase of cir-

culating medium and of spending. At the beginning of World War I and again at the beginning of World War II the reserves of the banking system of the United States and, especially, of the Federal Reserve banks were such as to permit a great increase of checking accounts. And these deposits subject to check soon became substantially larger than they had been previously.

Business activity rather than business depression is certainly to be desired. General and widespread employment of wage earners is, obviously, vastly preferable to unemployment. And, therefore, an increase of circulating medium and consequent increase of spending is clearly beneficial if and in so far as it promotes employment and business activity. Especially in the midst of desperate war when every effort must be made to produce sufficient guns, planes, tanks and ships, is it undesirable that we should suffer the waste of widespread unemployment.

But this does not mean that we want to go on increasing the circulating medium rapidly and indefinitely. Indeed, even during the progress of war such an increase is a frequent cause of trouble. As soon as any lingering dullness of business has been overcome, further increase of money and checking accounts operates definitely and solely in the direction of price increases. And a general increase of prices, if it does occur, involves unfairness to holders of money, since they find it buys less and less the longer it is held. It involves unfairness to lenders, since the money owed to them decreases in purchasing power from month to month and from year to year. It involves unfairness to—and deception of—investors in government bonds. For the money paid them when the bonds are due will buy a smaller amount—unless the upward trend of prices is reversed—than when the bonds were purchased. The incomes of many workers, too, change but slowly in adjustment to changes in the cost of living. Yet

to reverse the upward trend of prices by decreasing the volume of circulating medium, e.g., by sharp restriction of bank credit, may bring business depression.

On the other hand, the attempt to hold prices down by law while simultaneously increasing the volume of circulating medium is also likely to be attended with serious difficulties. There is rationing with all its complications and its nuisance to the public. There are "black markets." There are evasions through deteriorations in quality. There are the demands of various blocs, such as the "farm bloc," that the prices of what they have to sell shall not be regulated on the same basis as prices of other commodities. There are demands that wages shall be raised for this and that group of workers. And experience shows that, in fact, the average of prices does rise and may rise considerably.

Although, all things considered, a stable general level of commodity prices is probably desirable, it is also probably true that, with it, business activity is not quite as great as it sometimes is during a period of rising prices. For our economic system, even though in large degree competitive, is by no means completely so and, indeed, is definitely less fully competitive than it ought to be in the interest of the general well-being. And each monopolistic group has a tendency to push its prices to the most profitable height, thereby somewhat decreasing sales. Labor groups endeavor to put wage scales as high as possible even though employment is thus somewhat diminished,—trying, of course, to keep what employment there is for their own members. Spokesmen for farmers may attempt to secure legislation limiting the output of various agricultural products, thereby tending to decrease the opportunities for employment in agriculture. Producers in other lines may attempt, through agreements or combinations, to raise the prices of the goods they have to sell. In these and other ways, we may be prevented from

enjoying the possible maximum of production and employment.

But when the volume of circulating medium is being greatly and rapidly increased, the chances are that, for a time, these various groups or interests will not raise their prices, wages and rentals in proportion. The increase of circulating medium "steals a march" on them. They do not at once realize that, compared to the new economic possibilities, they are receiving smaller gains than they have been receiving. And so their ordinarily more or less chronic retardation of business activity and employment is temporarily somewhat in abeyance!

But it is doubtful whether even continuous inflation with its otherwise objectionable features, would remedy this evil for very long. For if such inflation came to be thought of by the various monopolistic and quasi-monopolistic groups as normal and as to be expected continuously, they would be likely to begin pushing up their own prices rapidly enough to prevent the fullest possible business activity. The increase of circulating medium would then not be "stealing a march" on them.

Furthermore, even if it were possible, by means of continuous and progressive increase of money and bank credit, to keep always one jump ahead of the monopolistic groups, this *would not be the logical or the right solution.* The right solution would be to carry out a consistently anti-monopoly policy and thereby to be able to maintain both steadily active business and a stable general level of prices.

III

IT HAS BECOME the custom in certain quarters to hold war responsible for depressions that come in later days of peace. Indeed, in the political campaign of 1932, in the United States, it was argued, on one side, that the depression of 1929 and following years was really due to the war of 1914–1918!

The year 1919, following directly after the war, was a year of continued and rapid increase of circulating medium. Bank credit and Federal Reserve notes in circulation expanded greatly. Business was at a peak of activity. In 1920 Federal Reserve policy was one of bank credit restriction and the crisis of late 1920 was followed by a two-year depression. Business was active again in 1923 and remained generally active, though with a mild recession in 1927, until the latter part of 1929. But in 1929, again, Federal Reserve policy was one of bank credit restriction and in 1929, as in 1920, we experienced the beginning of business depression.

If war, besides being debited with its own obvious evils, is to be the scapegoat for business depressions occurring ten or twelve years after peace is restored, one wonders whether it may be made the scapegoat for depressions occurring twenty and thirty years after. Perhaps the Civil War was responsible not only for the depression of 1873–1879 but even for that of 1893–1897! Perhaps World War II will be blamed for all the depressions of the next hundred years!

The truth is that sharp and persistent restriction of circulating medium brings business depression equally after wars or before them and would presumably bring depression—were there any serious likelihood of monetary restriction at such a time—in the very midst of war. If there is anything in the idea that depression is to be looked for as an aftermath of war, this can be only because and to the extent that sharp and persistent restriction of circulating medium is more likely to occur after a war than at other times. We have just seen that, during war, there is likely to be great and rapid expansion of currency as a means (but not a desirable means) of financing the war. And after such expansion there is likely to be—has frequently been—some attempt to get back, through restriction, to the pre-war basis. In the United States, for example, the boom of 1919–1920, following al-

most at once after the cessation of hostilities, involved further expansion of bank credit beyond that of the war years and, finally, a greatly reduced per cent of reserves of the Federal Reserve banks to deposits and outstanding Federal Reserve notes. This may very well have been a principal reason why the Federal Reserve Board adopted its policy of sharply restricting credit in 1920 and a reason, therefore, why we experienced the depression of 1921–1922. But to say this is far from saying that the war of 1914–1918 *caused* the depression of 1921–1922. And to say that the war of 1914–1918 caused the depression of 1929 and the years following is still more far fetched.

In Great Britain, steps were taken, in the years following World War I, to decrease the circulating medium and bring the price level down to something like its former level—to get back to the former relation of the currency to gold—with a like consequence of business depression. It was not the war, as such, but monetary restriction, that should be held responsible for the succeeding dull business.

What, therefore, can we reasonably expect if, shortly after the end of World War II, there should be sharp and persistent restriction of bank credit (and so of the volume of circulating medium) both in Great Britain and the United States? Should this occur, no amount of preliminary "planning" by business men's committees, of new and old lines of production and of new construction, would suffice to prevent widespread unemployment.

IV

But why should decrease of circulating medium bring business depression?

Clearly, if restriction of bank credit—or decrease of the circulating medium through direct government action—involves any substantial decrease of spending, it must involve *either* lower prices in at least the same proportion as spending

is reduced *or* decreased business. And prices are not likely to decrease both as far and as fast as does spending. As I have expressed the matter in my "Basic Principles of Economics":[1]

> Producers and dealers will not see why they should accept greatly reduced prices for their output and for the goods which they have bought to sell. They will lower their prices only with reluctance. Artisans and laborers will not easily be convinced that there is any adequate reason why they should take lower wages. Persons who have land and buildings to rent or to sell will not readily understand why they should accept lower rents or prices than those which they have come to look upon as reasonable. Speculative holders of vacant land will, in many or most cases, continue to ask the prices they have been asking. But with less money and credit being spent, unless prices in general fall in proportion, the volume of business must decline. Continued lack of demand for goods and labor, with unsalableness of the goods and diminished employment for laborers, will force a readjusting reduction in prices and wages. The will to maintain prosperity prices and wages is broken by the compulsion of circumstances.

And further, from the same book:[2]

> Curtailment of credit certainly must make for business depression if prices fall, unless and until production expenses such as wages and rentals also fall. But credit restriction must bring business depression no less surely if prices do not fall. For the resulting decrease of circulating medium must certainly decrease the demand for goods and, unless prices do fall proportionately, sales and, therefore, production and employment, must obviously decline.[3]

It may be said that this slowness of adjustment of prices and wages means lack of competition,—that there is, in it, a certain element of monopoly. But this does not mean that most prices and wages were, prior to the decrease of circulating medium, above a normal competitive level, although

[1] Columbia, Mo., Lucas Brothers, 1942, pp. 108–9.

[2] Ib., p. 111.

[3] It would lead away from the main thesis of this paper to discuss here all the phenomena that mark the downward path from prosperity to the bottom of depression. This downward path may manifest itself as a "vicious spiral of decreased circulating medium, dull business, falling prices, bank failures and further decrease of circulating medium" (ib., p. 112), including a derivative psychology that affects both the amount of borrowing and the rapidity (velocity) of spending.

some of them probably were so. What it means is that there is a certain inertia in readjustment; some of the prices and wages are "sticky." There is an economic "friction" not quickly overcome. And indeed, where there is clear monopoly and a more or less deliberate monopolistic resistance to reduction of specific prices or incomes, the depression is likely to be worse. For if demand for the monopolized goods does not appreciably decline, so causing decrease of employment in the monopolized line, the decrease of total spending must involve a more than proportionate decrease of demand for the products of other industries.

In any case, we may properly insist that depressions are not caused by war as such and that, granting intelligent and careful monetary policy they are not at all an inevitable aftermath of war. War may and does involve vast destruction of manpower and of capital. It may, therefore, appreciably reduce the productive efficiency of our economic society. But this does not mean that it must or will cause decrease of productive *activity* among the workers who survive it or decreased use of whatever capital is still available.

And as regards the extreme industrial activity or "prosperity" of war time, we have seen that this, too, is largely a monetary phenomenon. We have seen that such activity manifests itself in periods of peace. We have seen that, however, rapid and continuous inflation as a means of producing and maintaining such activity is hardly to be desired even if there were assurance that such inflation would indefinitely succeed in its purpose. A monetary policy calculated to maintain a substantially stable price level, and a general governmental policy of maintaining competition and preventing all kinds of monopolistic extortion, offer the best prospect of worth-while and abiding productive activity and employment.

V

What Are Profits?

FOR GENERATIONS—certainly for well over a hundred and sixty years—economists have distinguished three types of income from the productive process. These are income from labor, income from the ownership of capital and income from the ownership of land. Income from labor—at any rate when the labor is hired by an employer—has been called "wages." To the income from capital some writers, *e.g.*, Henry George, have applied the term "interest." And the income received by way of the ownership of land has commonly been called "rent" or, sometimes, "land rent" or "economic rent."

It cannot be said that there has been any one generally followed and unquestioned terminology. Economists—and there are some—who use both the term "rent" and also the term "interest" to refer alike to income from capital and income from land, may strenuously deny that the usage referred to above is the prevailing one. But something like this use of terms has been general enough so that we may perhaps refer to it as more widely accepted than any other.

However this may be as regards "interest" and "rent," there is wide variation in the use of the term "profits." And it may be worth while to inquire (1) whether any of the meanings most frequently given to the term makes it helpful in economic analysis; and (2) whether there is an advantage in having any such term in addition to the terms "wages," "interest" and "rent."

I

JOHN STUART MILL defined "profits" as including interest on capital, wages of management and compensation for risk. The same usage was followed by Alfred Marshall.

As against this concept of "profits" the question at once arises why we want to include wages of management along with interest on capital in a single term. Wages of management, as such, are received for work done. True, the particular kind of work is not of the manual variety, but neither is the work of the accountant or the clerk or of those junior executives whom the top executive hires. Indeed, the top executive himself is pretty likely to be, in these days of wide use of the corporate form of organization, an employee of a corporation. To class together the returns on capital, received by stockholders of (investors in) the corporation, and the wages (salary) of a hired president or manager, under the heading "profits," would certainly be incongruous. Why should not the wages of the hired manager be classed rather with the wages of junior executives, accountants, clerks, artisans and other employees, since all of these incomes are received *for working?*

Probably the economists who have defined "profits" so as to include wages of management, especially the earlier writers, were thinking of individually owned businesses rather than of corporations. But, even if so, it still seems that the incomes received by business managers *by virtue of* their managerial activities, should be classed with other incomes that are received *by virtue of* work done rather than with incomes received *by virtue of* ownership of capital (or of land).[1]

If we should follow in the inclusion of some wages and some interest in the term "profits" such writers as those referred to above, why should we not include some land rent in that term, also? If the return on his capital received by a man who is managing his own business is thought of as

[1] Even though a corporation is run, in the main, by a hired president or manager, the stockholders—at any rate some of the larger stockholders—may participate in management, as through attendance at stockholders' meetings. It may be contended, therefore, that some small part of their dividends should be reckoned, in strict theory, as "wages" for work.

"profits," along with that part of his return which comes from his management (and which, presumably, he would not receive if he hired a manager to do the work), why should we not include also, as part of his "profits," the part of his income that he receives by virtue of his ownership of land?

The tradition among economists is not to include this last in "profits." But the individual business man managing his own little business generally does so. Whatever he gains from his business over outlays for his goods, wages for his employees and payments made for the use of land and capital belonging to others, he is likely to refer to as "profits." He will not usually make any separation of his own gains into income from his labor, income from his capital and income from his land. Actually, a part of his income is due to his work, managerial or otherwise, for, if he did not work, his income would, in general, be considerably less. Another part is due to his ownership of land. This part he could enjoy even though he did no work, for potential tenants would be found ready to compete with each other in offering him rent for the use of his land. Still another part is derived from his capital and this part, too, since others are ready to pay him for the use of his capital, he could enjoy regardless of whether or not he works. But instead of saying that he receives these three kinds of income—which are conveniently referred to as wages for work, rent of land and interest on capital—he is likely to call the total his "profits."

The individual who owns and operates a business is likely to think chiefly of the net income from his business and to be interested relatively little in tracing this total income to its various sources. The term "profits" may involve as much analysis as he cares to be bothered with!

But what if (say) his land and capital together could be leased to another business man who would pay for their use

$10,000 a year net (in excess of depreciation), whereas he is himself able to make only $10,050 a year from running his own business. That would indicate that his managerial labor for an entire year adds only $50 to the income he could enjoy if he did no work at all. It would presumably indicate that he was wasting his time in work for which he was not fitted and that he should either change to other work or, perhaps, devote his time to other things than earning (or trying to earn) a living. Thus, even to the individual proprietor who may imagine that he is not interested in dividing "profits" into its economically significant components, such division may be important as a guide to wise action.

II

BUT IF THE INDIVIDUAL business man, often, is not interested in an inquiry regarding the different factors from which his income is drawn and how much of his income is attributable or "imputable" to each, the student of economics ought nevertheless to be greatly interested. For such analysis is essential to an understanding of our economic order and, especially, to an appraisal of its fairness. Surely there is reason for distinguishing between an income which an individual receives from work that adds to the total output of enjoyable goods and, on the other hand, income which he receives by virtue of holding title to a part of the earth. The latter kind of income he could receive without work, merely by charging a tenant for *permission* to use that part of the earth.

To inquire here on a specific question of public policy, may it not be economically desirable to tax more heavily an income which owners of land can thus enjoy merely for *permitting* others to work on or live on the earth, than an income earned by productive labor?

There is a difference, too, between an income derived from

permitting men to work on the earth and to enjoy community-produced location advantages and, on the other hand, an income from capital brought into existence by means of one's own saving. As for the practical application of this distinction, it should be noted that a high tax on capital or the income from it may possibly discourage the saving necessary to produce it or may cause the capital to be invested in some other state or country where such a tax is not levied. But a land-value tax will not decrease the total amount of land or cause land to be transferred from one state or country to another!

Surely the student of economics interested in public policy cannot afford to rest satisfied with the lumping together of wages and interest and rent in a single term "profits." Rather will such a student insist—at any rate he ought to insist—on putting into one class all incomes from land, whether derived from an individual landowner's private business or paid to him by a tenant or tenants or received in the form of dividends on the stock of a corporation owning and using land. Such a student will—at any rate he should—insist on putting into one class all incomes from capital and distinguishing such incomes from land rent, even though the particular owner makes no distinction and calls them both "profits."[2] And the student of economics will wish to class

[2] Because it involves something of a digression from the main theme, I am not including in the text above any analysis of the excess gains of monopoly. Such excess gains may accrue to labor, if one or more persons are protected by labor union or governmental or other restriction against the competition of other workers in the particular occupation. They may accrue to the owners of capital, if the capital of rivals is in a similar manner excluded from the particular industry, *e.g.*, by the threat or actuality of unfair competition on the part of the would-be monopolist. And they may accrue to the owners of land, if other land is forcibly kept out of the particular line of production, as by the quota restrictions in the Agricultural Adjustment Act or by the threat of unfair competition, or if, through complete monopoly by one company or monopolistic collusion among several companies, the number of coal or copper mines or oil wells in use is restricted so as to hold down output and thus hold up price. The excess gains of monopoly may be, therefore, excess wages or excess interest or excess rent or any two or all three of these. If this fact is kept clearly in mind, there is perhaps no objection to referring to the excess gains of monopoly as monopoly "profits." But then we should logically, it would seem, use the expression "monopoly profits" for the excess *wages* paid to workers

together also, for a large part of his analysis, all incomes from labor, whether the labor be managerial, "junior" managerial, clerical, statistical, professional or manual.

But how about the view that "profits" include a "compensation for risk"? Or the view that "profits" are nothing but the excess gains from fortunate enterprises or in fortunate years which compensate, more or less, for the losses from unlucky ventures or in unlucky years?

If we are consistent in this use of the term, must we not say that "profits" are so offset by "losses" that in the long run and on the average there are really no—or almost no—*net* "profits"? In other words, may it not be that, on the average, the returns from a business will just about equal the ordinary or normal rate of pay for the capital, land and labor devoted to it?

If we are to make a special point of income received as "compensation for risk" in the case of a corporation or other business concern, should we not do likewise in the case of the salesman who works on a commission basis? For he, too, is "compensated" for his "risk" of having inadequate income at certain times, by his chance of having appreciably larger income at other times. The fluctuations of his income, in other words, are not entirely or, perhaps, at all, the result of fluctuations in his effort, concentration and skill. Shall we then call the excess income of his lucky weeks or months his "profits"?

Indeed, even the employee who is paid by the day, week or month, may be said to assume some risk, for example, the

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in a trade where, by limiting the number of their competitors, *e.g.*, through limitation of apprentices, the workers in control of the trade are able to command higher wages for their labor than would otherwise be possible to them; or else we should distinguish between (say) *corporate* "monopoly profits" and *labor* "monopoly profits." And in thus referring to the "monopoly profits" of labor, we are including in "profits" incomes that are almost invariably thought of, spoken of and written of as "wages"!

But it is certainly important to distinguish between incomes earned in fair competition and the excess (and *unearned*) gains of monopoly, whether these excess gains accrue to capitalists, to landowners or to workers.

risk of periodical unemployment, the risk that failure of the employing concern will leave him minus some of his accrued wages, or the risk that his employer or some hired executive will abscond with the payroll, leaving the company without means to meet its wage obligations. Shall we then say that a small part of every worker's wages ought to be regarded as "compensation" for the "risk" that he will not continuously receive his full regular wage, and that this part should be separated in thought from the rest and be considered not as wages at all but as "profits"?

And how about the income received by the owner of a bond? May we not regard a certain part of this income as "compensation" for the "risk" that the full return promised, or possibly, even any return at all will not be realized? If so, just how much of the income received shall be thus reckoned separately from the rest and be classed with "profits"?

The truth is that there is risk in all the relations of life, including all the relations of business. Every type of income is subject to some possibility of fluctuation or irregularity, whether it be income from labor or from capital or from land. But to pick out a part of the income from each such source and put all these selected parts together under the heading "profits," tends to divert attention from the problem of the source or sources of the income. It tends to confusion in any attempt to attribute incomes to their respective sources, whether in productive contribution or in exploitation.

The choice of terms and of the meanings to be attached to them should be made in the light of the problem or problems we are seeking to solve. We should select and define our words with a view to emphasizing—not to blurring—the distinctions which need to be clear to us if we are to discover the cause and effect relations we seek and thereby further the adoption of wise and just policy.

III

If we consider "profits" as excess gains the possibility of which compensates for the risk of suffering losses, then we are directing our attention primarily to the *fluctuations* in incomes. If, indeed, it is the up and down fluctuations and, in general, the variations from the norm or average, rather than the average and normally-to-be-expected income in each industry and from each source, in which we are interested, this use of the term "profits" is relevant. But it is hardly relevant to an inquiry which would trace incomes to their sources in the so-called "factors of production," *viz.*, labor, land and capital.

Suppose we wish to examine critically the socialistic view that all incomes from property are unearned. We shall get no help in this venture from a demonstration that, in proportion as demand for a particular commodity is inconstant or unpredictable, the income from the capital used in its production is likely also to be inconstant or unpredictable, with the chance for gains above the average per cent offsetting the chances of lower than average gains and of positive loss.

Or suppose we are interested in a study of the rent of land. Suppose we are considering the fact that land rent is received from geologically-produced and community-produced advantages for which some men are allowed to charge other men. Suppose we are inquiring, then, whether land rent thus going to particular individuals is not really unearned. Suppose the question is raised whether the rent of land differs from both interest on capital and wages of labor, because it is not paid for any equivalent service rendered. Suppose, in short, that we are seeking to test incomes received by their relation to functions performed. Surely, in that case, we shall get no light from the fact that what a tenant agrees to pay for the use of a piece of land is sometimes a

fixed amount and sometimes a proportion of the output. In the latter case, a few writers might regard the above-average income of the landowner from his land, which he receives in good years, as "profits." But both the above-average income of good years and the below-average income of poor years he receives *by virtue of* his ownership of land and *not* by virtue of his *doing* productive work or of his owning capital brought into existence by work and saving.

In the voluntary agreements of business, it is customary for some persons to assume the major fluctuations in income and thereby guarantee, to some extent, more constant income to others. Thus, if the owner of land and capital hires a manager to operate the business in which they are used, he will probably agree to pay this manager a definite or constant wage ("salary") during some agreed period. He then accepts for himself a somewhat fluctuating and unpredictable rent from his land and interest from his capital. But if, on the other hand, the manager hires from the owner the land and capital to be used in the business, the conditions are reversed. The rent paid to the owner for his land and the interest on his capital are agreed upon in advance. They are constant or definite (barring business failure by the manager, or some kind of fraud) while the wages (though he may call them "profits") of the manager take the unpredictable fluctuations resulting from the changing circumstances of demand, "cost," etc.[3]

Or, again, the owner of a piece of land may be promised a definite or constant rent by a person (or a corporation) undertaking to construct buildings and other improvements to be used with the land in some kind of production. The owner of the improvements may hire workers for definite or constant wages. His own income—interest on his capital

[3] The continuously larger than average returns to the superior manager are, of course, to be regarded as wages and mirror such a manager's superior productiveness.

—is then subject to fluctuation and may be more than the usual per cent return on capital, or less, or he may lose some of his original investment. And if, instead of hiring a manager to operate the business to which his capital is thus devoted, he manages the business himself, then he receives unpredictable or fluctuating wages as well as unpredictable or fluctuating interest on his capital.

Still again, such a tenant may borrow part of the needed funds to construct the capital, providing the remainder from his own savings. If he does so, then the interest from his own capital used in the business is unpredictable and subject to fluctuation while the lender's interest and the landowner's rent are, both of them, relatively constant and predictable.

By means of these various agreements, freely entered into in the operation of the system of free private enterprise, some accept relatively fluctuating and uncertain rent or interest or wages while others arrange for rent or interest or wages that are relatively constant and certain. But the fact that some accept more risk than others does not change or in any essential respect weaken the argument for distinguishing among the various incomes on the basis of whether they are due, respectively, to the recipients' labor, to their ownership of capital that has been brought into existence through work and saving, or to their ownership of part of the earth.

If the use of the term "profits" diverts attention from such a functional analysis—and often, I think, it does—it may seriously interfere with the development of a general understanding of what is most fundamentally awry in the division of the product of industry among the various contracting parties concerned with it.

VI

Taxation According to "Ability to Pay"

What It Means and What Is Wrong With It

WHEN IT IS PROPOSED that the annual rental value of land, geologically produced and community produced, be made the first source of public revenue, those who are implacably opposed to this reform present a variety of objections. Among these is the contention that such taxation would operate to the relief of the owners of capital, such as buildings, and to the relief of the recipients of large salaries, and that both classes "ought" to be required to pay appreciable—even large—sums in taxes.

Before discussing at length the major principles involved, it may properly be pointed out that to appropriate most of the rent of land to community needs does *not* necessarily mean the abolition of all other taxes. We can, therefore, combine with such heavy land-value taxation, *if we want to,* especially heavy taxes on the largest salaries, even though these are fairly earned by skill and hard work, and similar heavy taxes on the capital (or the income from it) of those who have a great deal of capital, regardless of how hard they may have worked to acquire it. We can use the revenue from an increased land-value tax, *if we want to,* for the purpose of lightening the tax burden only on the incomes of those who earn *low* wages (or "salaries"), on the capital of those who have but *little* capital and on commodities (*e.g.,* cigarettes and goods subject to a general retail sales tax) which are bought in considerable degree by the comparatively poor.

Nevertheless, it is highly important to emphasize the fact that the economic philosophy of these objectors is altogether

different from that of advocates of the public appropriation, by increased taxes, of land and site rent. These objectors to the land-value tax program are little interested—indeed, one is inclined to believe that most of them are not at all interested—in the *source* from which the taxpayer's income is derived. They are much more concerned with taxing heavily *large* incomes, however fully and fairly earned by service given to those from whom the incomes, in the last analysis, are received than they are concerned with taxing incomes which are not earned at all by any service rendered in return. That some should be able to derive incomes by charging others for *permission* to work on and live on the earth, in those locations where work is relatively effective and life relatively pleasant, does not especially disturb them. What disturbs them is, rather, that some persons have appreciably *larger* incomes than other persons. And this appears to disturb them just as much when such larger incomes are received in return for equivalent service rendered as when they are purely exploitative.

I

PERHAPS IT WILL HELP to bring home to the reader the principle involved in this controversy if we suppose a country where there is private ownership of seas, rivers, lakes and air and where, therefore, a large part of the people have to pay rent to the owners of such "property" for the *permission* of the latter to *transport* goods on—and to row, fish or swim in—the seas, rivers and lakes and to *breathe* the air. Suppose, then, an effort to bring it about that the rents paid to use seas, rivers, lakes and air—which the "owners" never themselves brought into existence—should be the first source of public revenue and, therefore, used for the benefit of all. Immediately it is objected that this arrangement might relieve of taxation some persons whose incomes, though fully earned

by the rendering of equivalent service in return, may nevertheless be larger than the incomes received by some of the poorer owners of sections of seas, lakes or rivers or some of the owners of small amounts of the country's air or some not very prosperous owners of very small lakes!

Such concern over the inequality of income resulting from inequality of contribution, together with comparative indifference to the problem of exploitation, is nearly identical with the attitude of those who urge charity to aid the poor but have no interest in *justice*. If, having understanding minds as well as sympathetic hearts, we were willing really to establish substantial justice—in the sense that incomes were received henceforth for services rendered and not through chicanery, monopoly, slavery *or* charging men for *permission* to use the earth—there would certainly be much less need for charity.

Those who express such great concern lest sizable *earned* incomes be somewhat relieved of taxation by making the rent of land a first source of public revenue are probably, in general, adherents of the "ability theory" of taxation. They believe that taxes "ought" to be levied on a basis of "ability to pay."

The idea of basing taxes on ability to pay grows out of the fact that a dollar has less significance to a person who has many dollars than to one who has few. To a person whose income is already large an additional dollar means only the ability to buy some inconsequential luxury. In the case of a person whose income is very small, on the other hand, the lack of a single dollar of it may mean deprivation of sufficient food, clothing or other necessity. The contention is made, therefore, that taxes on the larger incomes involve less "sacrifice" from the taxpayer than taxes of similar amounts on the smaller incomes and that taxes on the larger incomes should be greater.

But how much greater? So far, the notion that taxes should be based on "ability to pay" is vague. How much more "ability to pay" goes with a $50,000 income than with a $2,000 income?

Here we need to consider two somewhat divergent branches of the "ability" idea. One is that taxes "ought" to be so levied as to impose "equal sacrifice" on the different taxpayers. The other is that taxes should be so levied as to impose the *least aggregate* or *total* sacrifice.

Individuals differ in needs, tastes and desires, and so we cannot be certain that two persons of equal incomes will be undergoing equal sacrifice if they are equally taxed. However, it is evidently assumed by those who hold the "equal sacrifice" philosophy that for practical purposes we are not to bother with individual tastes and habits but only with differences of income and of relatively necessary expense (such as the expense imposed by dependents). Then, presumably, a rough guess would be made regarding "equality" of sacrifice. Such a guess might be, for example, that an annual tax contribution of $15,000 from a person with a $50,000 income involves a sacrifice "equal to" that imposed on the recipient of a $2,000 income by an annual tax of $10!

But the question inevitably obtrudes itself whether anyone, anywhere, at any time, has worked out or could possibly work out cogent evidence to show what *would* be "equality" of sacrifice. Might it *possibly* be the case that the phrase "equality and sacrifice" is just a slogan used to persuade an unanalytical public to accept the policy of those who use the expression?

But why should we want taxes levied so as to make the "sacrifice" of different taxpayers precisely *equal?* Is the word "equal," in this connection, anything more than a euphemism? Why not claim that the *amount* contributed

by different taxpayers should be "equal"? Or that each should contribute an "equal" per cent? Is there any reason from the point of view of logic, ethics or the welfare of the social group why the thing to be made "equal" in the case of different taxpayers should be their "sacrifice"? Indeed, why not make the "sacrifice" very *unequal* in order that the magic word "equal" may be applied to the net income remaining to taxpayers after tax contributions are subtracted? Is there, in short, any really *convincing* argument for having the word "equal" apply to sacrifice rather than to *amount of tax contribution* or *per cent* of income taken or *amount of income left* for individual spending, *except* that some economists *intuitively feel* that way about it? Are not some of our mentors, in fact, giving us a mumbo-jumbo economics?

If there is nevertheless some sort of case for taxing the larger incomes more heavily so that sacrifice between different taxpayers is "equal," may there not be a still more plausible case for so levying taxes as to produce the *least possible aggregate* sacrifice? In this view, if $15,000 has been taken in taxation from a $50,000 income and still more revenue is needed, whether $10 more or $100 more or even $32,000 more, this additional amount should still be taken from the $50,000 income *before anything at all* is taken from the $2,000 income. Indeed, even if $47,000 ($15,000 plus $32,000) has been taken in taxation from the $50,000 income, there still remains $3,000, and so a dollar still has less utility (or importance) to such a taxpayer than to the recipient of an annual income of $2,000. Therefore, if (say) another $900 is needed by government, there will be *less sacrifice* imposed *in the aggregate* if this, too, is taken from the $50,000 income, bringing the recipient's net income down to $2,100, than if it is taken from the $2,000 income. And likewise if still another $99 or even $100 is needed by gov-

ernment, less aggregate sacrifice will be imposed by taking it also from the larger income, reducing this to a net of \$2,001 or \$2,000, than by taking it from the smaller income of \$2,000 and so reducing the smaller income to a net of only \$1,901 or \$1,900.

But what if the expenses of government do not require so much revenue and such high taxes as we have just been assuming? And what if, therefore, the recipients of the initially larger incomes still have more left, *even though they pay all of the taxes,* than have the recipients of smaller incomes?

The logical answer, from the point of view of one who favors taxation to impose least aggregate sacrifice, would be that, since additional wealth has greater utility to the recipients of the smaller incomes than to those whose incomes are large, *i.e.,* since their *need* is greater, therefore government should increase its levy on the larger incomes and spend the resulting additional funds mostly in providing services gratis for the needy. In other words, the only logical stopping place for the advocate of taxation according to least aggregate sacrifice is the communistic terminus of equal incomes for all,—or, perhaps, "from each according to his capacity, to each according to his need."

But any such scheme of taxation and public expenditure, it will be said, would largely weaken the motive to efficiency. If the more competent and efficient worker, who earns more by virtue of his superior efficiency, is to have all—or even the major part—of such additional earnings taken from him, is it equally likely that he will work thus efficiently? And is it equally likely that he will spend the time and effort to become thus competent? If the benefit of his extra effort is to flow, not to those of his own family, for whom his affection is presumably the strongest, but to the entire community

in larger tax revenues, is it humanly likely that he will feel the same incentive to effort? If to undergo an extended period of training for a difficult profession is to add little or nothing to the trainee's income, can we be confident that men will be as eager as now to undergo such training? Under the direction of Nicolai Lenin, even the communistically-minded Russian Bolsheviks abandoned their earlier communistic ideal of equality of incomes and began to pay more to the skilled and efficient than to the inefficient, the unskilled and the untrained.

But to say all this is to admit that "ability" or "sacrifice" should, at most, not be our only basis for the apportionment of taxes. And we may find, as we go on with our inquiry, that not only the matter of incentive to efficiency but also other important considerations have been and constantly are being overlooked or ignored by the tax theorists who prate so earnestly of comparative "sacrifice" and of "ability to pay."

II

ONE CONSIDERATION which certainly ought not to be overlooked is the possible effect of taxation on saving and, therefore, on the available total of capital. Inadequate capital means less and poorer equipment for a country's working force. It means lower productiveness of labor. And so, other things equal, it means lower wages.

If capital is very heavily taxed or if the income which it yields is very heavily taxed, there is at least some basis for doubting whether the amount of saving and, therefore, the amount of capital equipment will not be less. Certainly this possibility should not be completely ignored in planning a system of public revenue. If those who save are allowed to gain but a tiny share of the extra wealth the capital they have saved makes possible, they may have less motive for saving. And certainly the ability to continue to save and to save

increasing amounts, on the part of those who have acquired the habit of saving, is lessened by such a tax.

A variant of this idea that high taxes on capital or its income may decrease the amount of capital-in-general, is the idea that such taxes may make impossible the accumulation of "venture capital." In a recent article, "Capitalism in the Postwar World,"[1] Professor Joseph A. Schumpeter of Harvard University undertakes to present an analysis of the way in which certain forces, political and economic, threaten or may threaten the continuance of "capitalism." Among the influences he mentions is heavy taxation which largely absorbs the gains of enterprise and investment. In this connection he refers to "burdens which eliminate capitalist motivation and make it impossible to accumulate venture capital, with risks of borrowing greatly increased."[2] And in an appended footnote he goes on to say: "High or highly progressive taxation of profits increases the risks of borrowing for purposes of long-run investment, because it absorbs profits the accumulation of which might be counted on to take care of subsequent losses."

Perhaps "capitalism" *is* thus threatened. The general property tax, levied locally, takes a large slice of the annual yield of capital for the use of local and, in a considerable part of the country, state government. The income taxes levied by the states and the federal government take a large proportionate part of the remaining income of those whose incomes are high in any given year. And the excess profits tax levied on the gains of business takes another considerable slice. Conceivably a continuance—and, especially, a further increase—of such taxes would end all possibility of relying on private saving for the construction of a fairly sufficient amount of capital equipment. Were such a condition to

[1] Chapter VI of "Postwar Economic Problems," edited by Seymour E. Harris, New York, McGraw-Hill, 1943.

[2] *Ibid.*, p. 121.

confront us, we should probably be told that the free private enterprise system was "incapable of meeting modern needs." The final result might be a more or less complete socialization and regimentation of industry.

But why do not writers like Schumpeter call attention to the fact that a tax taking all or most of the annual geologically-produced and community-produced *rental value of land* does *not* remove the motive to accumulate?[3] Why do they not remind us that the more we take in taxation of this income which is *not* the product of individual work or efficiency or saving ("thrift"), the more can other taxes be reduced? Is it because the land question has been ignored so long in the economics courses of the colleges and universities that, in general, the economists trained in them are entirely unfamiliar with it and that, therefore, the idea of suggesting an increased tax on land values seldom even occurs to them!

There is another group or "school" of economists, active participants in recent discussions on the causation of business depression, who ought logically to oppose heavy taxation of capital and, it seems to me, to support, in place of it, high taxation of land values. These are the economists whose view it is that very low returns on capital conduce to business depression through causing men to hold idle, waiting for a more favorable conjuncture, funds they would otherwise lend or invest.[4] Because of such *hoarding*, demand for goods and labor is reduced, business activity is retarded and workers are subjected to unemployment.

"The concept of *Hoarding*," says Lord Keynes,[5] who is generally considered to be the leader of this group or school

[3] As regards the "risks of borrowing," it should be noted that land-value taxation lowers the sale price of land and so reduces—and may reduce greatly—the amount of borrowing necessary. See my "Basic Principles of Economics," Columbia, Mo., Lucas Brothers, 1942, especially Appendix 6.

[4] See J. M. Keynes, "The General Theory of Employment, Interest and Money," New York, Harcourt, Brace and Co., 1936, especially Chapters XIII and XVI.

[5] *Ibid.*, page 174.

of economists, "may be regarded as a first approximation to the concept of *Liquidity-preference*. Indeed, if we were to substitute 'propensity to hoard' for 'hoarding,' it would come to substantially the same thing."

To examine adequately here into the theory of business depression would take us too far afield from our main topic.[6] Indeed, even to discuss more in detail the distinctive position of this special school of economists, with its reference (for example) to the response of borrowers to the hoarding propensities (at low interest rates) of lenders, would be, I think, an unwarranted digression. Suffice it to say that *if* a very low rate of return on capital would be likely to conduce in any way either to initiate or to prolong business depression, then there is a further reason for abolishing—or at least appreciably reducing—taxation of capital and its income. For obviously the net return on capital to the owners of it is much less when capital is heavily taxed than if it were not taxed.

Owners of capital presumably receive, on the average, about what capital yields or produces (its "marginal" productivity) *minus* what government takes by way of taxation. The more government takes, the less remains to owners. If, therefore, there is *anything at all* in this theory lately so much publicized, viz., that very low rates of return to owners tend to hoarding and thus conduce to business depression, its protagonists should readily admit that removal or substantial reduction of taxes on capital and on its income would help to avoid depression. And they ought to admit with equal readiness that public appropriation of all or practically all of the annual rental value of land and sites would *not* reduce the net per cent return either on present capital or on the savings which become embodied in future capital. Furthermore, they might reasonably be expected to be more

[6] My own view of the causation of business depression is presented in my "Basic Principles of Economics," Chapter VI.

vocal than the majority of other economists in pointing out that to remove or, at least, greatly reduce taxes on capital and the income from it and, instead, to tax more heavily the geologically-produced and community-produced (location advantages) value of land, would leave the desired *larger net per cent returns* to savers and investors.[7] *If they are not thus vocal, what can be the reason!*

But even if we are unconvinced that hoarding induced by taxation of capital or its income, and a resulting low net return, has or could have any causal relation to business depression, and even if we refuse to admit that taxation of capital may tend to reduce saving and investment and thus involve a decreased total amount of capital, there is still the question of the effect such taxation may have in reducing the available amount of capital in a particular state or nation. For if in one jurisdiction or state, capital is very heavily taxed, whereas in another jurisdiction it is taxed less or not at all, investors will certainly prefer, with other conditions anything like equally favorable, to send their savings for investment into the jurisdiction where capital is not taxed or is taxed but lightly. (If necessary to avoid future taxation on the income from such investment, they may themselves move.) For investors, like other men, *prefer more to less!* Thus the people in the state or jurisdiction where capital is heavily taxed may come to be less well provided with the capital needed for effective production.

What sort of economic "science" is it which bases its tax theory on intuitive slogans such as "equal sacrifice," which ignores the possible effect of taxation on thrift and the aggregate amount of capital, which ignores the effect of taxation

[7] Although, of course, they might argue that such larger net returns would stimulate saving, increase the total amount of capital and so, eventually, cause the net rate of return again to fall. But any such argument surely involves an admission that, for some time at least, the net rate to savers and investors would be higher and that, during such time, the alleged depression-producing influence of a very low rate of return must be destroyed or appreciably lessened!

in any given community in causing those whose saving makes capital possible to invest in *other* communities, and which ignores entirely any bearing taxation may have on the incentive to efficiency?

III

BUT THIS IS NOT ALL. Everyone who is acquainted with the facts knows that very considerable quantities of land are held wastefully vacant for years in the hope of a rise in the price at which they can be sold or, sometimes, in the determination not to sell for less than the potential seller has paid. This tends to crowding and slums in the cities, to lower productiveness of labor (*e.g.*, because much land near cities and, therefore, well located for truck farming and dairying, remains vacant and unused awaiting a hoped-for suburban residential use which may be delayed for decades or never materialize at all),[8] and to various other wastes. Taxation according to "ability to pay" or according to any system of equal or least sacrifice means that these considerations also are altogether ignored. In fact, there is a tendency to commiserate with the speculative holder of vacant land and assess his property for taxation at a relatively lower per cent of its actual value than other property, despite his being a cause of waste and of loss to the community. "Poor chap!" it is said. "He certainly shouldn't be taxed much on his vacant land since he isn't making anything on it. He hasn't really much 'ability' to pay taxes on it."

But taxes ought to be levied with a view to *promoting the common welfare*. And a heavy land-value tax, as a result of which men *could not afford* to keep others—by high prices for land—from using land they themselves do not use, would definitely promote the common welfare.

Not rightly to be ignored, either, is the question of tenancy.

[8] For a fuller discussion of this problem, see my book on "The Economic Basis of Tax Reform," Columbia, Mo., Lucas Brothers, 1932, Chapter IV, § 3.

Decade by decade the proportion of tenants to owners, in the case of American farmers, mounts threateningly. And in the cities, also, non-owners have to pay owners for permission to use the sites on which they live and on which they work. High land-value taxation would make the price of land low. It would make possible great reduction in the burden of other taxes as well as increased productivity of labor and higher wages. The would-be owner of his home or farm could earn more, save faster and buy land far more cheaply. His rise from tenancy to independent ownership would be far easier. *And the social consequences of this might well be profound.*

Yet all this is entirely ignored by those who, when questions are raised regarding taxation and the tax burden, are able merely to mouth such phrases as "ability to pay" and "equal sacrifice."

"The educated classes," said a distinguished sociologist of an earlier generation,[9] "are victims of the phrase. Phrases are rhetorical flourishes. They are artifices of suggestion. They are the same old tricks of the medicine man adapted to an age of literature and common schools."

The one tax which can be urged most consistently with a defense of "capitalism" (the system of free enterprise) is a tax which appropriates practically all of the annual rental value of land. Such a tax does *not* discourage efficiency. It does *not* penalize thrift and the construction of capital. It does *not* impose a burden on so-called "venture capital." It penalizes only the *interference* with production which comes from holding good land out of use. It takes for the use of the public only the geologically-produced and community-produced rental value of land. The fact that this tax is not enthusiastically supported by protagonists of the system of free enterprise who claim to dislike communism

[9] William Graham Sumner, "Folkways," Boston, Ginn, 1907, p. 179.

and all its works, can be attributed, it would seem, only to one or more of the following reasons:

(1) The "silent treatment" which the land-value tax has had in educational institutions has brought it about that many men who might be interested do not even think of it—perhaps, often, have never heard of it.

(2) Various fallacies and superficial considerations, such as those I have discussed in this paper and other papers in this JOURNAL and in my book on "The Economic Basis of Tax Reform," have definitely prejudiced some minds against it.

(3) Some men who claim to desire a system of free enterprise are primarily interested—or only interested—in their own gains and so are more eager to preserve incomes *inconsistent* with the principles they pretend to appeal to than they are to establish a fair and decent "capitalism."

Business leaders as individuals, and business men's organizations and their committees, may sometimes comment adversely to heavy tax penalities on efficiency, thrift and enterprise, much as has been done herein. But when they do so it is seldom if ever that they suggest, as an alternative, the taxation of the geologically-produced and community-produced rent of land. On the contrary, they are likely to be found urging an extension of the general sales tax or the levy of other taxes which rest heavily on common folks, which definitely increase the tax burdens of men who have but small incomes and incomes that they truly earn by hard work. Reformers of that ilk have not the slightest interest in removing or reducing taxes on production as such or on the contributions of capital and of labor as such. Their only interest is in removing taxes from the larger incomes (and, therefore, their own incomes or the incomes of the class with

which they are closely associated) and putting them, instead, on the smaller incomes. What wonder if their pretense of being interested in efficiency and thrift and productive contribution is sometimes greeted with lifted eyebrows! Does such pretense really deserve anything better than hoots and jeers!

It may possibly turn out, in the end, that the stresses in our economic system induced by such features as the fact that some must pay others for *permission* to use the earth, will, if the system is not reformed consistently with freedom, bring us to regimentation and socialism. Reform of the economic system along the line of keeping it a system of free enterprise, requires intelligent understanding. If trained economists and business leaders cannot understand or, because of prejudice or self-interest, will not help in this *most fundamental* of reforms—to establish the right to work on and live on the earth—changes may be made, blunderingly, along lines utterly different. That has been the trend in Europe and, recently, in America too. I do not venture to predict. No one has a magic crystal ball in which he can see the future with accuracy. But who will say that there is no threat of socialism, communism or other regimented economic system?

We need a liberalism of the older sort, a liberalism which demands justice and has confidence that justice and freedom are the best guarantees of an efficient and good economy. The recent so-called "liberalism" denies justice, refuses men equal rights to live on and work on the earth and attempts instead to provide for the masses by taxing the earnings of any who strive for superior efficiency. It offers charity for justice. And whatever proper place charity has in the general scheme of things, to substitute it for justice—and without giving justice a trial—is an evidence of decadence. We

have been, indeed, in our economic theory, in a sort of "dark ages." In fact, the treatment meted out by various text-book-writing economists to the analyses of Henry George has been not only contemptibly biased but also (and I do *not* mean this as an anti-climax) utterly unscientific.

IV

PERHAPS THE OUTSTANDING ECONOMIC PHENOMENON of our time is the practically complete socialization of industry in Russia. And Russia's military might in this greatest war of all history is certainly helping to give prestige to her economic system.

An article in a news magazine last year, commenting on the frantic efforts of "the wealthy and great" of Rumania to escape from the advancing Russians, remarked that the discomfort of rich Rumanians was increased by "more and more sly grins on peasant faces." The peasants, said the writer, "have nothing to lose in the flight of Rumania's mighty" and "have nothing to fear from Russia's Red Army."

How many of the unpropertied workers in other countries have exulted, secretly if not openly, at the triumphant advance of that same Red Army? To how many of them are the growing influence of Russia and the growing prestige of Russia's economic system omens of a future when the earth shall be the inheritance of all men and not the property of a relatively few?

The "system of free private enterprise," *if so reformed as to make it consistent with the principles on the basis of which it is commonly defended*, would be definitely preferable, I believe, to any system of regimented socialism. But the adoption of a socialistic economy seems *less unlikely* than it did only a few decades ago. And I am inclined to think that this is, in part at least, because most protagonists of our so-called free enterprise system do not really understand it and

do not see—even when they are not unwilling to see—how it must be reformed if it is to operate really as in their defenses of it they say it does. Land-value taxation is, indeed, not the only reform needed. All forms of monopoly and monopolistic conspiracy must be adequately dealt with. Our monetary and banking system must be such as to make for stability in the general price level, to the end that inflation shall not enrich borrowers at the expense of lenders nor deflation bring ruin to borrowers and widespread unemployment to wage earners. But unless our reforms encompass land-value taxation, and, therefore, a practical recognition of the right of all to use the earth, they will not be enough.

VII

Anticipation of an Increment and the 'Unearned Decrement' in Land Values

A Study of Some Irrelevant Theorizing

IT CAN HARDLY BE POINTED OUT too often that the socialization of the rent of land—brought about through the method of taxation—is utterly different from the taxation of future increments in land values. Indeed, the philosophy on which the former is supported is, ordinarily, a different economic philosophy altogether from that of those economists who, after rejecting the proposal to appropriate the rent of land, or most of it, in taxation, yet profess themselves not opposed to a tax on future increases in land values. For most of this latter group are believers in "the ability theory of taxation" and either accept the taxation of future increments in land values as supplementary to taxes based on "ability" or consider that such increment taxes are themselves justified because of the increased "ability" to pay of the owner of the land which has become more valuable.

The point of view of those who favor public appropriation of the annual rental value of sites and natural resources, is that taxes should be so levied as to further the common welfare and that taxes based mainly on "ability" will not do this. They stress the annual rental value of land, regardless whether the rent, or the sale price, for that matter, *is rising* or is *higher* this year than in some previous year, and regardless whether the owner has received more than the usual per cent gain on the price he paid for the land or, indeed, any gain at all over his outlay. They stress the fact that the *annual rent* of land is a geologically- and socially-produced value; that the individual is not responsible for it and that it is socially undesira-

ble for the private individual to enjoy it. They insist that, when individuals enjoy the rent of land as private income, the rest of the community has to pay for *permission* to work on and to live on the earth, *in those locations* which geological forces and community development have made comparatively productive and livable. They point out that the private enjoyment of rent makes for a high sale price of land, makes relatively difficult the acquisition of ownership by the hardworking and ambitious tenant and makes for the continuance and the increase of tenancy. They note the wide extent to which land is held vacant and unused, or in only partial use, and maintain that this involves economic waste and decreased productivity of labor and greater crowding in slums. They call attention to the fact that not to take the rent of land as a first source of public revenue compels drawing more heavily on the earnings of labor and of thrift. And they conclude that a society in which the annual rent of land, geologically produced and community produced, is taken in taxation for public needs, in which monopoly gains and the gains from unfair business practices, etc., are eliminated, and where, therefore, the incomes of individuals are in some reasonable relation to the services rendered by them, would be a far better society for the ordinary person to live in than the economic society we now have. Surely, any advocacy of a tax system based almost exclusively on "ability," and so with no reference to these tremendously important considerations, must be the result either of a woefully inadequate understanding of the present economic set-up or of indifference to its evils.

I

TAXATION of *future increases only,* in the value of land, is at best, and even apart from its administrative complications and difficulties, a poor and inconsequential substitute for the

socialization of rent. But a large number of professional economists are opposed even to this inadequate measure. Some of them argue that no increase in land value can be regarded as unearned unless its recipient has gained, *in relation to the price he paid for the land,* more than the current rate of interest. Furthermore, when and if it is proved that a particular owner has thus profited by more than the ordinary interest on capital, another objection is raised. This objection is to the effect that the owner took a *risk* of his land *decreasing* in value—or, even, of its increasing by *less* than enough to yield him the *current interest rate* on the price he paid for his land—and that the lucky increases must be regarded as offsets against the unlucky losses. As some economists express it, we must remember that there is not uniformly an "unearned increment"; there is, in many cases, an "unearned decrement." And some of these writers raise the question whether, if a tax is levied on any increment, there should not be compensation awarded in the case of a decrement![1]

Surely, the view that the private enjoyment of land rent involves exploitation of the landless is quite different from the view that the only unearned income to be considered is this increase in value during the ownership of the particular individual, that even this increase is not unearned if the rate of increase plus the annual income is not more than the usual per cent return on capital, and that it is still not unearned, however excessive the rate, if, on the average, such increments are balanced by decrements.

Back in 1924 I discussed at some length the attitude of some economists to the subject of future increments of land value and their taxation, in an article entitled "The Single-

[1] See, for example, Hoagland, "Real Estate Principles," New York, McGraw-Hill 1940, p. 460; Kiekhofer, "Economic Principles, Problems and Policies," revised edition New York, Appleton-Century, 1941, p. 555; and "Modern Economics," by Moore Steiner, Arkin and Colton, New York, Nelson, 1940, p. 341.

Tax Complex of Some Contemporary Economists."[2] A few months later there appeared a reply to this article, by Dr. Wilford I. King.[3] In Dr. King's article, the point of view of the writers I had criticized on the matter of increments and the ordinary rate of return on investment is restated. Seeking to express this point of view in somewhat striking and popular form, Dr. King refers to himself throughout as a "patient" suffering, with the economists I had criticized, from the "single-tax complex." Since he brings increment, decrement, rate of return on investment and the view of conservative economists that even future increments should not be taxed, all together into a single paragraph, it may be well to quote this paragraph here in full:

> There is one ray of light in the blackness surrounding the mental condition of the patient which may mean that there is still hope of his rehabilitation. He says that he sees clearly the rank injustice of allowing to exist in a free country a medium which promises to the speculator a sure return—an "unearned increment." The patient is in general opposed to monopoly and in addition it is probable that he has a personal grievance for he continually asserts that someone has monopolized the formula for making easy money on land. He says that a man once gave him a tip as to how it was done but that the information proved false, for when, following directions, he bought the land, it failed to rise in value rapidly enough even to pay interest on his investment. He further says that several of his friends have had similar bad luck. I am sure that nothing will be more effective in hastening the patient's recovery than for Dr. Brown to point out just how the speculators go at it to get the "unearned increment" and not incur equally "unearned" losses. The patient asserts that when this point is cleared up in his mind he will be in favor of having the state seize the nefarious gains of the speculators.

Certain implications of this view had already been stated, in my article to which Dr. King was replying, in the following sentences:

[2] *Journal of Political Economy*, April, 1924. This article has since been reprinted, with very considerable additions, as Chapter IV of "The Economic Basis of Tax Reform," Columbia, Mo., Lucas Bros., 1932.

[3] "The Single-Tax Complex Analyzed," *Journal of Political Economy*, Oct. 1924.

Except as we suppose that landowners, owners of monopolies, etc., *under-estimate* the future possibilities of income from their property—and they are, perhaps, as likely to overestimate—there is certainly no possibility of ever giving the non-landowning and non-monopoly-owning public *anything whatever*, even through purchase, without trenching on the "vested rights" of the owners. The landless must continue to pay owners for the privilege of living on or working on their land or they must pay the owners, in advance, not only the capitalized value of the present rent but the capitalized value of any future increases in the rent which the owners may have a reasonable prospect of being able to charge. Similarly, consumers must continue to pay monopoly prices to the owners of monopolies or else they must pay such owners, in advance, the capitalized value not of the present monopoly profits only but, if increased prices may be looked for in the future, of the estimated additional future profits also.

That anticipated future rents of land are capitalized into a present sale price, and that the sale price of land is as much subject to the influence of persons who over-anticipate the future as of those who under-anticipate it, are opinions held quite widely by advocates of the socialization of rent as well as by opponents of it. But the former do not consider the fact of capitalization a conclusive argument against this basic reform, any more than they consider such an argument conclusive against tariff reduction, abolition of monopoly extortion, or other changes in public economic policy.

II

THE ATTITUDE EXPRESSED IN Dr. King's article, and which I have indicated is a common one among the authors of textbooks in economics, is expressed in, perhaps, a more generalized form by Dr. Frank H. Knight in a review of Dr. George Raymond Geiger's book, "The Philosophy of Henry George." The paragraphs of particular significance follow:

As everyone knows, the social philosophy of Henry George pivoted around and found its expression in the doctrine of the "single tax"—more accurately the social appropriation of the income from land. The theory underlying this doctrine is one of the most rudimentary and obvious of all

the fallacies ever promulgated in the name of economics. It is of the very conception of economic behavior that, in so far as the individual knows what he is doing, the "return" from any activity, as estimated by himself, will be equal to the outgo, in terms of the individual's own estimate of the next best alternative of the resources employed. Any return amounting to more or less than "cost," in this sense (which is the only sense having any intelligible meaning), is due to accident or miscalculation,—i.e., to the speculative element in the activity. There is no evidence, a priori or empirical, either (a) that speculative activity yields a larger return, in any representative sample of cases, than does activity where the results are actually in accord with expectations, or (b) that land acquisition or holding presents anything peculiar in comparison with other economic activities. Every type of speculative element is familiar in connection with land and also in other connections. . . .

All this reasoning is on a mental level not above that involved in the simpler operations of arithmetic. The economic and social ideas of Henry George as a whole are at the same pre-arithmetical level, the level of those held before and since by all who have held any at all, apart from an insignificant handful of competent economists and other negligible exceptions. Henry George's claim to be an economist (or social philosopher either) rests on the possession of linguistic powers not uncommon among frontier preachers, politicians, and journalists, and on the fact that his particular nostrum for the salvation of society appeals to a number of people, no doubt for much the same reasons that made it appeal to him, and which give many other nostrums their appeal.[4]

Professor Knight is here more frankly contemptuous of Henry George than are most of the latter's critics. But the very forthrightness of his contempt may help to focus attention more clearly on the divergence in economic philosophy which I am here trying to emphasize. And I believe it is important to do this. For Professor King and Professor Knight, despite any peculiarities in their individual formulations of the matter, are representative of a whole group of present-day economists, and views essentially the same as theirs are continually appearing in college text-books.

The fact is that Henry George did not base his advocacy of the socialization of rent on the opinion that landowners,

[4] *Journal of Political Economy,* Oct. 1933.

in general or on the average, enjoy any exceptional rate of return on their investment. It is true that he sought to illustrate the effect on land values, of the rise and development of cities, by dramatic reference to the fact that men may—and do—become millionaires as a consequence of such rise and development.[5] But he refers, also, to the case of persons who are "land poor"[6] and to the fact that anticipated increases in the rent of land are reflected in its present price.[7] Indeed, he even points out that the mere expectation of the adoption of his proposed reform, as public opinion became increasingly favorable to it, would bring a reduction in the sale price of land *before* the reform actually went into effect.[8] Conceivably, Professor Knight can ferret out some sentence in Henry George's many writings that is not absolutely consistent with his own generalized statement quoted at length above. But, surely, here is no unfamiliarity with the theory of capitalization and no naïve assumption that, in general, the purchaser of land can hope for extraordinary gains.

And even though extraordinary gains have been realized at times, this was not at all the main burden of Henry George's complaint. What he was endeavoring chiefly to make clear was that *the annual rent of land,* whether it be increasing *or* decreasing, is an income analogous, in large degree, to income from the ownership of slaves, and that permitting the private enjoyment of this rent inevitably tends to make poverty a concomitant of progress. Indeed, again and again in his books and controversial articles, he compared private enjoyment of the rent of land with the profits of slavery. He would not have argued that the slave-owner's rate of return on his "investment" in slaves was a greater per cent than his return on his investment in buildings or other

[5] "Progress and Poverty," Fiftieth Anniversary Edition, New York, Robert Schalkenbach Foundation, 1929, pp. 241, 294.

[6] *Ib.*, p. 258.

[7] *Ib.*, pp. 361–2.

[8] "A Perplexed Philosopher," *Works of Henry George*, Vol. V, New York, Doubleday, Page & Co., 1904, p. 233.

capital,[9] but he would have insistently maintained that the income from slave-owning was exploitative none the less.

III

PERHAPS IT WILL HELP to bring home the real basis of Henry George's thinking, to those inclined to go along with Professor Knight, if I venture what may appear, superficially, to be a rather far-fetched illustration. But though superficially it may appear far-fetched, it is, I am sure, very closely analogous to the case regarding land.

Let us suppose, then, that lakes and rivers have long been recognized as subject to private ownership, as well as land, and that large income has been securable from charging ships for *permission* to sail on them. This would be exploitative and *would certainly not be to the general advantage.* Yet here, too, the rate of return over "cost," to the owners, might well be not more than—might even be less than—the ordinary rate of return on the capital that men make. And if we cannot assume a return greater than the ordinary per cent on "cost" for those who may have bought out the first owners or the descendants of these owners, neither can we assume a greater return to these owners (or their descendants) themselves. For however the first owners acquired their ownership, whether by force, by bribery, or through some legally sanctioned method, there was some sort of "cost" involved. (Conceivably, in certain circumstances where public sentiment was not wholly approving, a troubled conscience might be a considerable part of this "cost.") And the prospective owners would have been ready to meet this cost whenever or as soon as it was justified by the anticipated returns.

More specifically, let us now suppose that, some hundreds of years ago, legal sanction regularly attached to perpetual

9 See "The Condition of Labor," in "The Land Question," New York, Robert Schalkenbach Foundation, 1935, p. 103.

control of a lake, e.g., Lake Michigan, if certain formalities were attended to, and that these formalities were the rowing three times around the lake and the performing of certain incantations at the end of every third mile. This would certainly mean, so far as any would-be owner was concerned, a *cost* of acquisition.

Now let us assume the future income from such ownership, of millions of dollars a year, to be confidently anticipated by two or more aspirants for ownership.[10] Then each of these would be ready to do the rowing, bearing all the incident toil and danger, and to perform the incantations, at the earliest date when it could be said to pay. In other words, they would be willing to do this as soon as the *capitalized value* of the future income such ownership was expected to yield became equal to the cost of so acquiring ownership.

Then Dr. Knight could piously pronounce with regard to such ownership of Lake Michigan, as with regard to ownership in land—or in slaves!—that "there is no evidence, a priori or empirical, . . . that the acquisition or holding of a lake—or of slaves—presents anything peculiar in comparison with other economic activities. Every type of speculative activity is familiar in connection with lakes—or slaves—and also in other connections."

But such pronouncement would have no bearing on the question whether deriving private income from charging men to use Lake Michigan—or other bodies of water—was socially desirable or was in any significant way analogous to deriving private income from productive capital the construction of which private saving has made possible. Whatever the *cost* of *acquiring title* to Lake Michigan, there has been no *service* to the community from this acquisition, nor

[10] Because an adequate return might not be obtainable otherwise during the lifetime of any of these and because they might not, any of them, be willing to make the investment solely for the sake of a remote decedent, we should perhaps assume, also, that it is possible to sell, decades later, to equally confident anticipators belonging to a later generation, and these to still other and later would-be purchasers of the property, and so on.

any service to future users of the lake who must pay large annual sums for *permission* to use it. Whatever the advantages to commerce of Lake Michigan and of its harbors, these advantages are not services rendered by the owner (or owners) of the lake. They are not due to his effort. They are not the consequence of his construction of capital. They do not result from and are not enhanced by his rowing three times around the lake and performing the specified incantations nor by such action on the part of any ancestor or other previous holder of title. The difference between receiving private income from such "property" and from capital which one's own productive effort and saving have made possible is fundamental and profound. It is this difference which Henry George stressed and on which the land-value-taxation theory is based.

The man who acquired title to the lake several hundred years back may have realized—through his heirs—no more than or even less than the ordinary rate of return on *cost,* the return which he could normally have realized by bringing into existence new and useful capital. The important point is that, though the per cent return thus received may be, on the average, no greater, and may sometimes be less, nevertheless this return cannot be justified on the basis of equivalent productive contribution to those who must pay it; whereas the return on capital can normally be so justified.

If now, at some date say fifty or a hundred years or more, after title to the lake has been gained by means of the prescribed rowing and incantations, the property is sold to a new purchaser, the price paid will presumably be fixed on the basis of the then anticipated future yield. The new owner, therefore, having purchased at a price fixed by capitalization of this anticipated income, will also make, unless calculations have been inaccurate, only the *ordinary* rate of return. But *anything* he so receives, be it only one tenth of one per cent

on his investment, or even much less *than* the investment, is at the expense of the common run of folks from whom it is really drawn and who gain *nothing* from the fact that *the new exploiter may have paid a substantial amount to the previous exploiter* whom he has thus bought out.

IV

JUST BECAUSE THE DOMINANT influences in government some hundreds of years back had established such a system and just because the exploited masses—whether from intellectual confusion furthered by interested propaganda, or other cause—had allowed the system to continue until the present, it would be argued by apologists of the system that those exploited by it must let it continue forever. Or it would be contended that those who were being exploited by it must do nothing to change the system *unless* they first *fully compensated* the exploiter (or exploiters) for henceforth giving up the privilege of thus exploiting. The victims of the system must remain victims forever or must themselves pay for their own relief. And so the only method or methods of terminating the system, which could be regarded as in any sense politically feasible or practicable, would probably be ruled out at the start.

The parallelism with the present land system and the private enjoyment of the geologically-produced and community-produced rent of land is, in all essential respects, complete.

In the case of land, "society" is considered by economists opposed to the socialization of rent, to be, as it were, under a binding "pledge" not to change the tax system in that direction by one iota. It does not matter that this "pledge" has never been formally made or that, if ever made in any way or sense whatever, it has not been agreed to, consciously and understandingly, by its victims. It does not matter that there is a strong tendency—and has been throughout the his-

tory of landlordism—to soft-pedal the subject of landlord exploitation, to soft-pedal it or ignore it in the public press and in institutions of higher learning; that the victims of it, therefore, have had small chance to know the basic cause of their unhappy predicament; that these victims have, because of this lack of understanding, ignored the basic evil and supported, often, inconsequential or, even, foolishly revolutionary reforms. It does not matter that the "pledge" by "society" not to change the tax system in the direction of public appropriation of land rent is usually nothing but a long-continued custom or habit in taxation and that taxation has been changed in such various ways as to suggest to prospective land purchasers the *lack* of any *fixed* taxation policy or custom or habit. Nevertheless, it is assumed that "society" is morally bound. And the victims of the present land system have been part of that "society" which has for many years followed the practice—or custom, or habit?—of *not* appropriating to public use more than a minor proportion of the community-produced rent of land. And since it is "unjust" or "unfair" or "wrong" for "society" to change its policy, one supposes it must be wrong for the previously uncomprehending victims of the policy to *urge* a change in it, if and when they come to understand how it affects them. And even if *this* generation of victims should—by some miracle!—have grown up with the requisite understanding, it would still be wrong for them to urge a change. For if their urging were successful, owners of land who had made their purchases of it on the expectation of no appreciable change in tax policy, would find their land of less value because *this* generation of victims had departed from the attitude of the *previous* generation of victims! If it is "wrong" for "society" to change its tax system in this direction, even by slow steps, must it not be equally wrong for anybody—even the victims of the present set-up—to *urge* this "wrong" act?

When the Pennsylvania legislature established the Pittsburgh (and Scranton) graded tax system, it provided that the city tax rate on improvements should become, in 1914, only 90 per cent of the rate on land; that in 1916 it should be 80 per cent; in 1919, 70 per cent; in 1922, 60 per cent, and in 1925, 50 per cent. This meant that to get the same revenue for the city, the tax on land values had to be gradually raised. To the ordinary person, such a change may seem quite within the rights of the legislature to make and not much more startling than it would be to raise the tax rate on motion picture entertainments while reducing the rate on cigarettes. But according to the published views of some American economists, the members of the Pennsylvania legislature, in passing such legislation, must be considered guilty of a *wrongful* act.

What if such tax changes as that in Pittsburgh and Scranton, the establishment of a land-value-tax system in Sydney, Australia, and other cities and towns within the British empire, the provision for land-value taxation passed by the British parliament in 1931 (since repealed by a Tory-controlled Commons), and the years of protest against the present land system by those who would reform it,—what if all these things have brought it about, as might conceivably be the case, that the sale price of land is somewhat lower than it otherwise would be! This, of course, because buyers and sellers of land allow for the *chance* that higher land-value taxation will be realized in a not too distant future. Or what if, after decades of effective education of the public mind by advocates of the socialization of rent, so many would-be buyers and would-be sellers of land believe this reform inevitable and imminent that land sells at a definitely lower price because of this anticipation than it otherwise would!

What if, then, a *more gradual* introduction of the reform

than was generally expected, actually causes the sale price of land to *rise* when the law is passed, instead of to fall! In that case, *what* person or persons have been guilty of unfairness or injustice to landowners? Is it the legislators whose *unexpectedly moderate beginning* of the change fills owners of land with a sense of relief and joy? Or is it the propagandists of the previous decades and years whose agitation brought it about that land had already a lower sale value before any actual steps toward enacting the reform were taken by the legislators, than the value it would have had if there had been no agitation? If the latter is the correct view, according to professorial economist text-book writers, is the sin in the *speaking* and *writing* of these disturbing thoughts of the land-value-tax propagandists or is it in the very *thinking* of these thoughts?

"Dangerous thoughts!"

V

IN AT LEAST TWO previous publications[11] I have expressed the opinion that the "sense of proportion of many persons, including not a few professional economists, seems to have been hopelessly dulled by their making of the doctrine of vested rights a veritable fetish. Otherwise, the view that society, which makes frequent changes of policy in other matters, is under a binding implied pledge and obligation *never* to move, *no matter how gradually,* toward the eventual taking in taxation of the major part of the rent of natural resources and sites, would be clearly seen to be, as in fact it is, *utterly silly.*" And many years ago, in "A Perplexed Philosopher,"[12] which most modern economists, even if they have chanced to read his "Progress and Poverty," have never read, Henry George discussed carefully and rather completely this whole question

[11] "The Economic Basis of Tax Reform," *op cit.*, p. 306, and "Basic Principles of Economics," Columbia, Mo., Lucas Bros., 1942, p. 464.

[12] Chapter XII.

of the right of society to socialize land rent. His discussion in this book seems to me a more thorough and searching one than the discussion of the same topic in "Progress and Poverty." It is perhaps unfortunate that so few have read it.

If "society" is under a moral obligation, by virtue of an implied "pledge," not to change any existing and long continued economic institution or tax system without full "compensation," are the *victims* of that institution or tax system properly to be regarded as a part of that "society"? If, for example, in a slave state, the slaves are thus to be regarded as part of the "society" and so as morally responsible for "society's" implied "pledges," and if the slaves eventually become numerous enough and strong enough, or get enough sympathizers to help them, so as to be thereafter the *dominant force* in the "society," what are their "rights"? Are they guilty of a *sinful act* in case they stage a revolution, establish a new government and become free *without* contributing anything in future taxes to "compensate" their former owners?

Tariffs on trade between countries have been subject to alternating increases and decreases. Taxes on the production of specific commodities have been successively introduced, increased, decreased, abolished and again introduced. Property taxes have been the main source of revenue, have been then supplemented by other taxes, have been increased and have been decreased. Federal income taxes have been introduced, abolished (by decision of the Supreme Court), reintroduced, increased, decreased and again increased. States which had previously taxed property but not incomes as such have added income taxes. These income taxes have been levied at a fixed per cent (above exemptions) and at graduated per cents according to the amount of the income taxed. Our Federal income tax has at one time been levied at the same rate on incomes of a given size, regardless of source and at another time has been levied at a higher rate on income

from property than on income from labor. Taxes on inheritances and bequests have been introduced and raised to very high levels after long immunity from such taxation had given the impression to accumulators of property that all of this property could be bequeathed to and be enjoyed by their heirs. The Federal government and the various state governments have levied excise taxes on specific articles, such as intoxicating beverages, cigarettes and gasoline and, later, many of the states have introduced, also, the general retail sales tax. One state legislature, that of Pennsylvania, has enacted the "graded tax law" applying to cities of the "second class" in Pennsylvania and providing for higher rates of taxation on land than on the buildings thereon. This is the system described above in this paper in connection with Pittsburgh. In various other sections of the United States campaigns have been waged and—sometimes—a substantial number of votes have been cast for a land value tax system. Not a few cities in Australia, Northwestern Canada and New Zealand tax sites and not improvements on them, or tax sites at a higher rate than improvements. Steps have been taken toward this system in Denmark and in British South Africa and the policy has been debated at length in Great Britain where a good many cities, through their local governments, have formally requested Parliament to make possible for them the system of (as they express it) "rating on land values."

Indeed, in many of our economic policies other than taxation, change has been frequent and, therefore, is reasonably to be expected. We first allow the manufacture of intoxicating beverages, then prohibit it, then allow it again. We allow monopolistic businesses to be free of prosecutions and of regulation and subsequently apply one or both of these devices. We permit young men to spend years of apprenticeship mastering a trade and later set up trade schools, or curricula in the regular public schools, in which we train other

young men to compete with them. We establish a monetary system through which the general price level sometimes rises and at other times falls. Some of our policies have been, indeed, unwise and unfair but, if so, it is because they are intrinsically bad and lead to bad results and not because they violate an implied "pledge" to make no changes. In the world in which we live, it is more accurate to say with the poet, Longfellow,[4] that

> All things must change
> To something new, to something strange:
> Nothing that is can pause or stay:
> The moon will wax, the moon will wane,
> The mist and cloud will turn to rain,
> The rain to mist and cloud again,
> Tomorrow be today.

In such a world of constant change, *including change in social and economic policies,* surely it is a *ridiculous* assumption that human beings are committing a *sin* when they try to change one particular line of policy—involving land rent and its taxation—of which they feel many are victims. Surely it is reasonable to presume, rather, that men purchase their property or make their other commitments knowing that tax policies and taxed objects have changed, do change and are likely again to change, and assuming this risk when they purchase.

Each substantial effort to educate the electorate to the advantages of the public appropriation, by taxation, of the major part of the rent of land, is a notice to landowners that they may not always be able—or that the next generation of owners may not be able—to live on the rent of land. Each step in substituting land value taxation for various other and relatively undesirable taxes constitutes a notice to owners of land to prepare for a time when they can no longer live by charging others for permission to work on those parts of the

[4] In *Keramos.*

earth where work is relatively productive or for permission to live on those parts of the earth where life is relatively pleasant or for permission to draw from the earth subsoil deposits placed there by geological forces.

Yet most of the text-books in the "principles" of economics, whose authors deign to give any attention at all to land-value taxation, conclude on the note of its "wrongfulness," on the note that "society" would be guilty, in making such a change, of "injustice," of an act of "bad faith," of "changing the rules of the game while the game is in progress." Such considerations in reply as have been presented above are not even mentioned. They are not mentioned even where the author makes a pretense of giving both sides of every "controversial subject" or says he means to be "meticulously objective" on such subjects. They are not mentioned even to express disapproval of them. The student, if he follows his text-book, is left with the definite impression that no reply can be made and that, therefore, the land-value-tax reform need not be taken seriously.

Perhaps this is one reason why those college graduates who are oppressed by the realization of the poverty and inequality that they see all about them, and who are inclined to social idealism, have tended to be influenced by socialist and communist ideology. For there has been too little in the college teaching of economics to give them the vision of what an economic system based on free markets and free enterprise might be, if so reformed as to make it consistent with the principles on which it is commonly defended. For then incomes would be received for *contributing* to production and not at all for *permitting* others to *use the earth.*

VIII

THE INCIDENCE OF A GENERAL OUTPUT OR A GENERAL SALES TAX

IT IS generally recognized by students of taxation that a tax on the output of a particular commodity raises the price of such a commodity by decreasing its supply. But what if there is a tax on the production of all commodities and services—an equal proportionate tax on all lines of production? Will such a tax raise prices? Clearly it cannot make any particular kind of commodity, such as cigarettes, relatively scarce by driving producers of it into other lines, for other lines of production are then equally taxed, and there is no advantage in leaving one taxed line for another line which is taxed to the same extent. Where, then, does the burden of the tax rest?

A good many persons too readily conclude that such a general tax must raise all prices. But there are important considerations which such persons overlook. Such a general tax cannot reduce the output of goods unless workers are willing to remain idle—for there is no untaxed line to go into—or unless owners of capital or land are willing to let their capital or land lie idle and to receive no income at all from it. Surely, most men would, in time, accept wages very considerably lower rather than be chronically idle, and most owners of capital would rather have very greatly reduced returns on their capital rather than let their capital depreciate unused and get no returns at all. Similarly, landowners—other than vacant-land speculators (and we need hardly conclude that a general output tax, apart from any incident reduction in land-value taxes, would increase the number of these)—would presumably rather receive lower rent than no rent.[1] We cannot expect, therefore, that a general tax on output would cause permanent cessation of production or that it would, as a long-run phenomenon, bring any appreciable decrease. Why suppose, then, that it could, in the long run, make prices higher?

[1] Of course vacant-land speculators, like other human beings, commonly prefer something to nothing. The circumstances which nevertheless make them hold their land unused, for a time receiving no rent, are set forth, at least partially, in my book on *The Economic Basis of Tax Reform* (Columbia, Mo.: Lucas Bros., 1932), pp. 268–74.

An increase in the volume of circulating medium, whether it be through the issue of additional money or an expansion of bank credit, tends definitely toward a higher range of prices. But there is certainly no obvious connection between a general tax on the output of goods and an increase of the volume of circulating medium. There is, therefore, no basis in monetary theory for supposing that a general tax on all goods will make average prices permanently higher. To raise the general level of prices there must be either a decrease of supply of goods in general or an increase of demand (as through an increased volume of money). If a tax on the output of all goods neither decreases supply nor increases demand, on what basis is it to be argued that such a tax will raise prices?

If a tax on all goods does not raise prices, it must lower the money incomes of (the number of dollars received by) workers, capitalists, and landowners. We shall begin with the workers. Here, let us say, is a coal-mine worker who is able to add to the output of a given mine one ton of coal a day. The coal is worth, at the mine mouth, $2.00 a ton. At a wage of $2.00 a day, this worker is barely worth hiring. Now, suppose there is an output tax of 10 per cent. When the coal is produced and sold, 20 cents must be paid as a tax to the government. That leaves only $1.80. The coal-mine worker whose labor adds this ton to the total output is no longer worth a maximum of $2.00 to the employing company but only a maximum of $1.80. For, if the company can sell this coal for no more than $2.00 and must pay 20 cents of this to the government, the ton of coal is worth, to the company, not over $1.80, and it cannot afford to hire the mine worker at any greater wage than $1.80. So far as the community is concerned, the worker's marginal productivity is $2.00. But, since the government takes 10 per cent of this, his marginal productivity is, to the employing company, only $1.80. If he wants to work, he cannot expect greater wages than his work is worth to the employing company. Nor, as we have seen, can the price of coal be permanently raised, for a similar tax is applied in every other industry and there is consequently no escape from the tax by changing to some other line. Thus, such a tax on the output of all commodities and services necessarily reduces wages.

Let us follow out one more illustration. A farm worker adds to the output of wheat 400 bushels a year. This is a "marginal" addition, what the worker can do on no-rent land or as the "final" worker hired on a piece of high-grade land (intensive margin). At a price of $1.00

per bushel, this comes to $400. But if government, by an output tax, takes $40 of the price, the farm worker cannot possibly be worth, to an employer (or to himself, if he is self-employed), $400, but only $360. If the 10 per cent tax is levied at each stage of production and there are several stages (e.g., wheat, flour, bread, retail distribution), we must, to avoid having duplication of taxation, levy the tax at each stage only on the addition of value made to the product at that stage. Or the tax might be levied at the very last stage (retail sales), in which case it will be reflected back through the various stages to the recipients of the various kinds of income, as will be shown, with due qualification, in succeeding paragraphs.

Such a tax on all output will reduce the income of the capitalist and of the landowner in the same proportion that it reduces the income of the worker,[2] but not in any greater proportion. And since wages are a much larger part of the total product of industry than is either interest on capital or rent of land, a general output tax takes more from the wages of labor than it takes from interest or rent.

Let us now see just how a general output tax reduces the return received by owners of capital. Suppose that a farmer believes that an investment of $1,000 in fertilizing or otherwise improving his farm will add to the output which his labor can bring, every year, by some sixty bushels or $60 (in excess of an allowance for depreciation). He could then afford to pay not over $60 annual interest, or 6 per cent, for a $1,000 loan. But if a general output tax takes $6.00 of the $60, the improvement adds only $54 to that value of the output which the farmer will have after paying the tax, and he would be losing money to pay more than 5.4 per cent interest. Were the lender himself to invest his savings in producton under his own direction, the tax would take an equal per cent of the output; hence, he might as well lend to someone else for a lower rate than before. And necessarily, under these conditions, the demand for loans will decline until lenders are receiving 10 per cent lower interest than previously, just as wage-earners must receive 10 per cent lower wages than before. (The part of the output required to offset capital depreciation is, of course, "imputable" to the labor and other factors used in constructing the capital, and the proportionate tax on that part of the output is shifted back upon these factors.)

It is the same in regard to the rent of land. Suppose, for example, that a coal-mine operator could afford to pay $10,000 a year, as royalty,

[2] See my book, *The Economic Basis of Tax Reform* (Columbia, Mo.: Lucas Bros., 1932), pp. 128–29.

for permission to exploit a given coal mine, the coal being worth $2.00 a ton. Is it not obvious that, if the coal output is taxed 10 per cent, so that the operator receives, in effect, only $1.80 per ton, he cannot afford to pay as high a royalty? And is it not also clear that, since no other would-be operator can afford to pay as high a royalty as before, the possible competition of operators will be reduced and royalties must fall?

Or let us suppose the case of a farmer who has too little land to employ his labor most effectively. By hiring a neighboring piece of land he can, we may suppose, add fifty bushels a year to his output of wheat, without working any harder or longer than before. Obviously, he could afford to pay not over fifty bushels a year as rent for the use of this extra piece of land, or, with wheat at $1.00 a bushel, not over $50. But if an output tax takes $5.00 of the $50, he cannot afford to pay over $45. Clearly, the net rent received by the landowner must be reduced.

If, then, there is a general tax on output, the money incomes received by laborers, capitalists, and landowners must all be reduced. Since, of the prices paid for goods, a part (in our illustration 10 per cent) is taken by government, only the remainder can go as wages, interest, and rent for the factors of production. The incidence of a general output tax is, then, in practical effect, the same as if it raised all prices (as most of the public seems to suppose it does) without either decreasing or increasing money incomes. For in either case there is a subtraction, proportioned to the tax, from the real incomes of wage receivers, interest receivers, and recipients of land rent. Whether commodity prices remain the same and money incomes fall or commodity prices rise and money incomes remain unchanged, the distribution of the tax burden would appear to be identical.

A general tax on output will easily commend itself to those persons who believe that taxes should rest on everybody in about equal proportion to their respective incomes or spendings, however small these may be, and *with no distinction as to sources* of income or as to kinds of property owned.[3]

The general output tax with which a majority of us are now most familiar is the general retail sales tax. In the American states where this tax has been adopted, it does not really apply to all retail transac-

[3] The reasons why I cannot subscribe to any such belief but consider it essential to distinguish between sources of income and, therefore, between kinds of property, I have set forth at length in *The Economic Basis of Tax Reform* (Columbia, Mo.: Lucas Bros., 1932).

tions. There are various exceptions to its generality, depending on the jurisdiction, e.g., newspapers, haircuts, laundry and cleaning service, shelter, foods. But in many of the states, retail food sales are taxed the same as any other sales. In so far as the retail sales tax, as above indicated, is not all-inclusive, but bears on some lines of production and exempts others, it tends to make some prices higher than others. But since this tax, in several of the states, is so nearly a general tax, we shall, for purposes of the present analysis, assume it to apply in all lines equally.

Nevertheless, no purely retail sales tax which is not at the same time ubiquitous can apply to the entire output of goods even in a single county or state (or country), if those who live within the given territory are engaged in trade with outsiders. And, therefore, a retail sales tax, levied on all retail sales in a given state but not levied ubiquitously, will raise retail prices in that state.

Let us consider, for example, the 3 per cent general retail sales tax in Michigan, assuming, for the present, no sales taxes in surrounding states. This means that goods on which a 3 per cent retail sales tax will be levied, if they are sold to Michigan consumers, can escape the tax if they are exported to other states. If the tax applied equally on exported goods, then the factors of production, labor, capital, and land, would have to accept lower money incomes. The money returns for wages, interest, and rent would be appreciably reduced. But since exported goods escape the tax, this result does not follow. Producers of goods face no tax—even on retailers whose demand for their goods might thus be reduced—if they ship their goods outside of the state. And they will obviously accept no lower net prices from dealers inside the state than from dealers outside. Retailers in Michigan must pay approximately as high prices for Michigan produced goods which have a ready out-of-state market as if there were no Michigan retail sales tax. And since the returns to labor, capital, and land used in retailing can hardly be kept at a permanently lower level in relation to returns in wholesaling, manufacturing, etc., than before, the prices paid for goods by Michigan consumers must presumably rise.

But can we have, in Michigan, wages, interest, and rent as high as before, producers' prices as high as before, wholesale prices as high as before, retail prices actually higher than before, and a sales tax going to the state government, while the volume of circulating medium in Michigan has not increased? The answer is that the volume of circulating medium in Michigan, under the assumed conditions, will increase. For, since the tax applies on sales in Michigan and not on

sales made out of state, and since, at the start, the money incomes of residents of Michigan are not greater than before, they simply cannot buy as many goods as before if retail prices are higher. Yet retail prices must be higher unless producers sell goods to Michigan retailers for less than before, since otherwise the retailers' incomes would be relatively too low. (If this is not at once obvious in the case of a 3 per cent sales tax, it certainly would be so if the tax were, say, 10 or 15 per cent.) And producers surely will not absorb the entire tax, or even any appreciable part of the tax, so long as they can avoid the tax by selling goods outside of the state. Looking at the matter, then, from any reasonable point of view, we must conclude that out-of-state sales will be relatively favored until the resulting increase of circulating medium within the state makes possible wages, interest, rents, producers' and manufacturers' prices, and wholesale prices approximately as high, in relation to the corresponding incomes and prices in surrounding states, as before, and retail prices higher by the amount of the tax. It is to be noted, of course, that the inflow of circulating medium from other states into Michigan will lower, but only to the slightest extent—since we are assuming these other states to be without general sales taxes and since only a little money would flow into Michigan from any one of them—the general price level in these states.

So far as concerns a general retail sales tax levied by a single state or by a very few states, our conclusion is that such a tax would raise retail prices in such a state or states by approximately the amount of the tax. The view of the man in the street that such a tax raises the prices of goods in general is, to this extent, confirmed.

There is another important qualification which ought to be noted here. Even if a retail sales tax is levied ubiquitously and at the same rate, there would still be some rise of retail prices. In the absence of friction (of which account is taken at a later point in this discussion), there would be an immediate adjustment of relative prices but no change in the general price level. Since the tax is levied at the point of retail sales, a wedge is driven, so to speak, between retail and wholesale prices. Wholesale prices, producers' prices, wages, interest, and rent—all these are slightly lowered. Retail prices are raised and exceed wholesale prices more than before by the amount of the tax.........

Instead of saying "Retail prices are raised and exceed wholesale prices more than before by the amount of the tax," I should have said: "Retail prices are raised and exceed wholesale prices more than before by the amount of the tax *minus the slight reduction in the wages*

interest, and rent received from retailing." For, since the tax lowers somewhat, in money terms, wages, interest, and rent generally, we must suppose that the wages, interest, and rent received from retail operations will go down proportionally. That is, we must suppose this *on the assumption of a relatively frictionless society in which the levy of the sales tax is followed almost at once by the re-establishment of perfect equilibrium*. To anyone who may criticize such an assumption as unrealistic, I would reply that *the existence of friction* is *specifically allowed for and some of its consequences pointed out* in later paragraphs of my paper.

The later sentences of the paragraph here being amended ought to be as follows:

> The decrease in the money incomes of workers, capitalists, and landowners is so balanced by the new tax receipts of the government that the total of the money incomes of individuals and government will buy as much as the incomes of individuals (and any previous government income) would formerly buy. Individually, the people have less money to spend. Collectively—through the sales-tax receipts, to be spent by the government—they have more to spend. The average of manufacturers' and other producers' prices, wholesale prices, retail prices, individual money incomes in the form of wages, interest, and rent, and government income remains unchanged, but manufacturers' and other producers' and wholesale prices are lower while retail prices are higher.

The reason for rephrasing is that the article, as first printed, gives the impression that the total of individual wages, interest, and rent, plus the new tax receipts of government, are precisely equal in money terms to the total of individual wages, interest, and rent prior to the tax; while retail prices are higher. This means that if the total of the incomes of individuals and government before the tax would just suffice to buy the annual output of goods at retail, after the tax these incomes would not suffice. Of course, a great many government purchases may be at wholesale and, therefore, at somewhat lower prices than before and, even if government purchases at retail, it may buy at a price not including the tax. Nevertheless, the statement should be so formulated as to allow for the possibility that the income of government consequent on the tax may be increased, in terms of money, more than wages, interest, and rent to individuals are decreased. This is quite consistent with an unchanged general price level, since wholesale prices, manufacturers' prices, and raw-material prices are all somewhat reduced.

In order that the long footnote on page 260 may be entirely consistent with the above correction, the next to the last sentence should be amended to read as follows: "But the essential point I am trying to stress now is that average prices (counting producers', wholesale, and retail prices and also individually received wages, interest, and rent and the governmentally received tax money) as actually charged and paid in the markets, are not made either higher or lower by output or sales taxes, and that the average is, therefore, the same regardless of where the 'wedge' is driven."

Some critics may still complain that the collecting of the tax is itself, in a sense, an addition to the total of transactions and that, conceivably, it may thereby slightly delay the spending of money directly for goods, thus modifying—but hardly more than infinitesimally—the conclusions

If the tax were levied at some earlier stage in production, instead of on retail sales, then we could speak of the "wedge" as being driven between prices at this earlier stage, the prices preceding this stage being lowered and those succeeding it being raised. But the average of all commodity prices would still not be affected.[4]

[4] If the tax is thus levied at an earlier stage, i.e., the "wedge" driven at an earlier stage, fewer prices are, of course, reduced by the tax and more prices are raised by it. Therefore, if the average commodity price level is to be the same, those relatively few prices which are reduced must be reduced to a greater degree, and the larger number which are raised must be only slightly raised. Perhaps one way of putting the matter—though I suspect it is a way that to most persons will be more confusing than illuminating—is to say that when the "wedge" is driven at an earlier stage, the "tax addition" (if we may so speak) to the price which the buyer at retail pays must also be paid by the retailer to the wholesaler, and so on, to the point of government collection. In a sense we may then say that the tax money paid by purchasers at retail goes through several hands on its way to government and that, therefore, this tax money is, during the period of such passing, prevented from acting on "net" prices (in the sense of prices minus tax) as quickly as if it did not pass through so many stages. Thus, "net" commodity prices (in this special sense of prices minus tax) will average lower than if the tax were collected at the point of retail sale. This was probably (or so I hope!) one of the ideas I had vaguely in mind in writing "Some Frequently Neglected Factors in the Incidence of Taxation" (*Journal of Political Economy*, Vol. XXVIII, No. 6 [June, 1920]), although enough in that article is definitely fallacious so that I am sure I could not then have really thought the problem through or fully understood it. But the essential point I am trying to stress now is that average prices (counting producers', wholesale, and retail prices) actually charged in the markets are not made either higher or lower by output or sales taxes, and that the average is, therefore, the same regardless of where the "wedge" is driven. And I want to take this opportunity to disavow anything in the earlier article here referred to which is inconsistent with the present treatment.

If a tax were levied at each stage of production, but only at a proportionate rate on the value added at that stage, then no commodity prices, whether producers' prices, wholesale dealers' prices, or retail prices, would be changed at all; but all money incomes received by individuals—wages, interest, and rent—would be lowered; and the money income received by the government for collective spending would be raised by an equivalent amount.[5] (This is on the assumption that this tax is not a substitute for other previously levied taxes but is to provide new revenue.) Such a tax really would be a "proportional" income tax "collected at source" and having "no exemptions."

Returning, now, to the general fact that retail sales taxes levied in one state, or only a few states, make retail prices higher by the amount of the tax than in areas where such a tax is not levied, we may take note of a qualification hitherto not commented on. Persons living in a state where a retail sales tax is levied, but near the borders of a state or states where there is no such tax, may do a considerable amount of shopping in such a near-by state or states. Conceivably, some retail establishments in towns near the borders of a state levying no sales tax could keep down their prices a bit, to avoid losing trade, perhaps paying less to some employees who would nevertheless continue to clerk for them because of immobility and lack of acceptable alternatives, and less as rentals for stores and sites having no equally good alternative use. But it is doubtful if this would occur to any noticeable extent, and the probability is that only those consumers would avoid the tax in any appreciable degree who really did shop beyond the state borders.

In most of the previous discussion we have been assuming absence of friction and, therefore, immediate adjustment of relative prices (including incomes) to the tax levy. Especially has no attention been paid to the theory of "sticky" prices, e.g., "sticky" wages and rentals. But when attention is paid to this theory, it is seen that the rapid and general introduction of sales taxes, though perhaps brought about, in part, by certain consequences and ideologies resulting from depression, itself tends to produce depression.

We have seen that a general and ubiquitous sales tax cannot, as a normal, long-run proposition, increase the general level of commodity prices. But now we may note that any general attempt to increase

[5] Of course, less individual spending and more collective spending might change the relative demands for and marginal cost of various kinds of goods and so have some effect on their relative prices.

commodity prices when there is no increase in purchasing power must tend to a decrease of sales and to dull business.

But if commodity prices are not increased, then, as we have seen, money wages, interest, and rent must fall. And if these (wages, interest, and rent) are "sticky" and so cannot be quickly adjusted, then there must obviously ensue a period of unemployment and generally dull business. The rapid introduction of sales taxes certainly tends to bring business depression and, if depression already exists, the introduction of such taxes must, it would seem, tend to retard recovery and to make the depression worse. (In a similar way, if wages are "sticky," the rapid introduction and increase of pay-roll taxes to provide for unemployment insurance and old age benefits must operate in the direction of unemployment.[6])

So here we are apparently treated to another of the various contradictions of this remarkable New Deal era. Depression has made more vocal and persistent the demands of real estate owners for "tax relief for real estate." Depression has increased the need for funds to care for the jobless. Depression has, therefore, promoted the spread of sales taxes. Yet, if the analysis presented above is, in any essential degree, correct, the spread of such taxes has also fostered depression, has put more workers out of jobs and caused increasing pressure for more sales taxes to care for these increasing unemployed, and has, by virtue of the consequent heavier taxes on the poor, brought nearer to the level of "reliefers"—perhaps not infrequently below the level—not a few of those who have continued to have comparatively steady employment. As the government, under the N.R.A., to a considerable extent offset its borrowing and spending recovery program directed to the increase of purchasing power by encouraging monopolistic price rises, and as it adopted a farm-aid program which put many tenants (especially in the South) out of employment, so it has followed a tax policy for the relief (partly) of those injured by the depression, which, itself, must have tended to cause and accentuate depression.

[6] While taxes on output result in reduced wages and interest and rent, the incidence of pay-roll taxes, like the incidence of compulsory insurance of workers against accident, is on wages. The subject of accident insurance I discussed in this connection in an article in the *Journal of Political Economy*, Vol. XXX, No. 1 (February, 1922), entitled "The Incidence of Compulsory Insurance of Workmen"; and this discussion was later republished as chap. vi of *The Economics of Taxation*. For a clear presentation of the theory of incidence as it relates to the new program of social security, with some reference to minor qualifying influences, see Russell S. Bauder, "Probable Incidence of Social Security Taxes," *American Economic Review*, Vol. XXVI, No. 3 (September, 1936).

IX

Currency Devaluation and International Trade

TRADE BETWEEN THE PEOPLE of different nations has long been bedevilled by protective tariffs. And now understanding of the problem is bedevilled by confusions about currency and its relation to gold.

One of the more widely circulated popular magazines published an editorial, more or less political, entitled "The Whole Story," in an issue that appeared just before the 1944 Presidential election. A passage from this editorial illustrates those confusions:

> Roosevelt said: "We know after this administration took office, Secretary Hull and I replaced high tariffs with a series of reciprocal trade agreements." The historian knows no such thing. For the whole story is that while the Hull agreements increased our imports slightly, Roosevelt reduced the gold content of the dollar, thereby at one stroke raising the effective wall against imports and more than nullifying everything Hull had done since.[1]

Here the writer of the editorial is asserting that President Roosevelt has not told "the whole story." And the editorial seems to be saying, further, that to reduce the gold content of the dollar, *i.e.*, to raise the official Treasury price of gold, has the same effect as to levy a so-called protective tariff. If this is the writer's meaning, then, certainly, it is his editorial that does not tell "the whole story."

I

IN THE EARLY DAYS of the New Deal there was a marked change in our monetary system. Previously there had been a gold standard with free coinage of gold. The gold eagle contained 258 grains of gold, 9/10 fine (25.8 gr. per dollar). This meant that it contained 232.2 grains of pure gold or, otherwise expressed, that pure gold was worth, at the mint, $20.67 an ounce. By the change made in 1933–1934, sometimes referred to as "devaluation of the dollar," the standard dollar became equal to 15 5/21 grains of gold, 9/10 fine. But no gold was to be thereafter coined for circulation in the United States. The above standard merely meant—and still means—that the United States Treasury price for pure gold is $35 per ounce. No citizen is permitted to have gold in quantity (although this does not mean that he cannot have gold watches or jewelry) but must sell to the Treasury any gold he obtains through importation or mining. However, it is possible to obtain a license from the Secretary of the Treasury

[1] *Life*, New York, Nov. 6, 1944.

permitting a manufacturer to have gold to work, and in this case the gold covered by the license can be purchased for $35 an ounce. Also, it is possible to get a license permitting the purchase of gold for shipment abroad, in which case the licensee—usually a bank—can purchase the gold from the Treasury at the same price of $35 per ounce. If, in case of a "favorable" balance of trade, American banks have unneeded balances abroad, they will bring gold into the United States and sell this gold to the Treasury, also for $35 per ounce.

Since we no longer use gold coins, the essential thing to note is clearly not now the weight of a gold coin but rather the official Treasury price for gold. There is significance in the gradual raising of this price (in 1933 and 1934) from $20.67 to $35 per ounce and there would be significance in a further change in this price, whether it were to be an additional increase or a reduction. But this by no means indicates that any change in the value of money in terms of gold necessarily carries with it a corresponding change in the value of money in relation to other goods.

In general, international trade may be described as an exchange of goods for goods. The people of any country engaged in such trade pay for the goods they buy abroad with the goods they sell abroad.[2] However, the use of gold as a medium for the settlement of balances between countries means that the people of a given country, *e.g.*, the United States, can, for a time, purchase abroad more goods than the goods other than gold which they send (sell) abroad, or vice versa. But such excess purchasing tends to be self-limiting. The more gold we send abroad in payment for excess imports, the less the gold is likely to be worth in the countries we send it to and the less it will buy there. *In terms of the gold* we thus send, *their prices become higher*. But the scarcity of gold here tends to make it more valuable here—to make the price of goods here fall. Thus, in the long run, since our prices are becoming progressively lower to foreigners and theirs are becoming higher to us, they are encouraged to buy more here while we are discouraged from buying so much there.

It is on the basis of a similar line of reasoning that it is contended that a country cannot stop or greatly reduce its purchases abroad, through the levy of a protective tariff, without stopping or reducing to as great an extent its sales abroad. Thus, a high tariff levied by the United States on imports from abroad, by directly blocking American purchases abroad, may bring about a flow of gold into the United States. In other words, foreigners, though unable to pay for our goods by sending anything (or

[2] Borrowing and lending between countries do not change the picture in its essentials and to discuss them here would involve unnecessary digression.

much) else, may continue for a time to purchase our goods with gold. But this tends to make gold progressively less valuable here and more valuable there. Foreigners therefore find the cost to them of American goods growing continually greater and, eventually, *must* decrease their purchases of us to whatever extent we permanently curtail our purchases of them.

A protective tariff, therefore, although levied for the purpose of restricting only imports and although its protagonists often express an interest in and a desire to promote large exports, actually works to reduce *both* imports *and* exports in (ultimately) about an equal degree.

In pursuing our inquiry further, let us suppose circumstances such as steadily falling prices in Europe consequent on restriction of bank credit there, or such as a considerable reduction in the tariff rates levied by the United States on European goods, which would induce larger purchases abroad by Americans. Temporarily we would purchase more goods abroad than we were selling abroad, paying the balance in gold. Such an excess of purchases could work—and, unless a policy of stabilizing the general price level were followed, probably would work—in the direction of monetary deflation in the United States and falling prices. It will be worth while to note just how this would come about under our present currency system.

If thus we are purchasing abroad more than we are selling abroad and these purchases are not being made on credit, settlement must presumably be made in gold. Since international obligations are balanced or cleared, ordinarily, through banks and since, in our assumed case, there is an excess obligation for goods purchased, owed by Americans to foreigners, the banks will take care of these obligations by sending gold. Thereby American banks can build up their deposit balances in European banks, on which they can sell bank drafts to Americans who need them to pay for goods they are importing from Europe.

But the banks which thus send gold abroad must first purchase this gold from the United States Treasury. Consider, for example, the case of a large metropolitan bank which is thus purchasing gold and paying for it to the Treasury by check. Such a check will be collected from this bank, via the Federal Reserve bank of its district, through subtraction from the deposit of the national bank in its Federal Reserve bank. But that deposit in the Federal Reserve bank *is the national bank's reserve.* Thus such purchasing of gold to replenish the foreign balances of American banks decreases the lending power of these banks through decreasing their reserves.

In my "Basic Principles of Economics" I have described the situation as follows:

> . . . Those whose purchases abroad in excess of their sales abroad cause the export of gold, have to pay for the excess of purchases by giving up checking accounts on their banks. The banks then buy the gold from the government (the checks for the gold being collected through their respective Federal Reserve banks) and send the gold abroad to provide credit balances in foreign banks, from which payment may be made to the foreign sellers of the goods. Or a Federal Reserve bank (or banks) may send over the gold and sell its resulting credit balance on the foreign bank or banks, to a member bank or banks. In either case, certain individuals or business firms in the United States have, as a result of their purchases abroad, smaller bank deposits; each of the member banks which serve them by transferring funds to the foreign sellers of goods, has smaller reserves in its Federal Reserve bank, for each member bank has to make settlement with or through its Reserve bank; and the Federal Reserve banks (with which or through which the United States Treasury finally collects for the gold) have decreased gold certificates. Since payment for the gold comes, finally, from the reserves of the Federal Reserve banks, this will cause sharp restriction of credit, dull business and falling prices, *unless* the Federal Reserve banks have, as they usually have had, reserves *much larger than the law requires.* In that case, they can allow their reserves to decrease while not restricting credit and even, if desirable, while expanding credit.[8]

Advocates of free or freer trade have stressed its long run advantages, and these are great. They have emphasized the fact that in so far as we thus buy more goods abroad—instead of from domestic producers—by just so much, in the long run, can we expect to sell more abroad. The fact has been brought out, too, that in so far as foreign trade enables us to get needed goods much cheaper than before, consumers are able to buy at home goods and services which they previously could not afford, thereby giving opportunity for employment producing such goods and services. And if an outflow of gold does decrease the volume of circulating medium, we have only to adjust ourselves to a lower level of *monetary* prices, wages and rentals; while the actual goods and services enjoyed are definitely larger and may be very much larger.

II

NEVERTHELESS, A DECREASE in circulating medium, if and to the extent that prices, including wages, are rigid or "sticky" (*i.e.*, do not quickly and easily become adjusted to the requisite lower level), may involve a degree of dullness of business and employment. And this fact may sometimes be seized on by opponents of tariff reduction as an excuse for their opposition.

The truth is, however, that this evil—in so far as it is to be considered as an evil—is brought about *through monetary influences* and *is not at all*

[8] *Op. cit.*, Columbia, Mo., Lucas Brothers, 1942, pp. 115–6.

a necessary consequence of tariff reduction. We can have credit restriction in foreign countries with resulting fall of prices in those countries *or*, we can have reduction or even abolition of our protective tariff, and we can have a definite and advantageous increase in our trade with foreign countries, and yet suffer no decrease of our own circulating medium and, therefore, no unhappy consequences from such decrease. How can this be managed?

One way to do this is to raise the official Treasury price for gold, not to raise it excessively but to *raise it just enough* so that our purchases abroad will not exceed, but will be merely equal to, our sales abroad. That, as we have seen, is the long run tendency anyhow. Any temporary excess of purchases abroad over sales abroad, which causes an outflow of gold, must, in time, come to an end. To raise the official price of gold in the way just indicated merely brings us at once to this equalization of purchases and sales to which we must in any case come eventually. How does it do this?

If the Treasury raises the price it charges for gold from $35 to (say) $36, a bank that ships gold to England or some other foreign country, in order to have a balance there and so be able to sell bank drafts to its customers who are purchasing goods there, *must charge more for such drafts.* The American purchasers of foreign goods, for whose convenience the gold is shipped, will find, unless the goods they are purchasing have actually fallen in price in the country of their production, that these goods are more expensive *to them,* since the gold which must be sent for payment *costs more in terms of American money.* This tends somewhat to restrict American purchases abroad.

On the other hand, the higher price charged for gold—and presumably, also, paid for gold—by the United States Treasury, means that, *to the foreigner,* American goods are cheaper than before. For the foreigner's gold—and, therefore, his money if its value is based on gold—is worth more in American money, and for a given sum in his money he can buy more American goods.

Thus a slight increase in the U. S. Treasury's official price of gold may be a means of re-establishing the balance between imports and exports. And such an increase of the official price of gold restores the balance *without* there intervening a period of decrease of circulating medium with the consequences likely to follow such a decrease.

Here I would like to emphasize again that such an equalization of sales and purchases *before* disequilibrium has been allowed to disturb the general price level or bring any other untoward condition is to be sharply distin-

guished, as regards the effect produced, from a protective tariff. For, as I pointed out at an earlier stage in this discussion, a protective tariff necessarily, in the long run, decreases *both* purchases abroad *and* sales abroad. It interferes with a specialization and a trade that would benefit both or all the countries concerned. But such a raising of the price of gold as has just been described does *not* prevent or decrease specialization and exchange. It merely prevents us from buying abroad more than we can pay for with the goods and services (other than gold) which we sell abroad. It merely serves to end quickly, and without waiting for it to force down the general level of prices, a disequilibrium which cannot, in any case, continue indefinitely.

It should be clear, therefore, I believe, that the passage quoted from the current editorial at the beginning of this article does *not* tell "the whole story." More than two years before the editorial was written I anticipated this confusion, pointing out in my book:

> It may appear, on a superficial view, that such raising of the price of gold interferes with foreign trade as much as would a protective tariff. *But this is not the case.* A protective tariff, as we have seen, in the long run necessarily *prevents,* or at least decreases, *both purchases abroad and sales abroad.* But an official raising of the price of gold, sufficient to stop an outflow of gold, *merely prevents us from purchasing abroad more than we can pay for by our sales abroad* (exports) of goods and services other than gold. It does not prevent us from buying abroad as much as we can pay for with the goods we produce to sell abroad (or from buying abroad on credit, if foreigners will extend us credit).
>
> To have a wisely managed currency means, in this regard, merely that any temporary disequilibrium between a country's imports and exports does not have to wait for correction until the country's price level has been lowered by a decrease of its currency resulting from an outflow of gold, but is corrected as quickly as desired and without serious unsettling effects on the country's business or price structure.[4]

With such handling as I have described, any decrease of tariff duties which would result in Americans *buying* more abroad would also and to an equivalent degree increase American *selling* abroad—and this not after the lapse of several years but quickly.

III

SUCH CONSIDERATIONS, it would seem, ought to cut the ground from under any last lingering objection to removal or substantial reduction of tariffs, based on fear of possible temporary effects in decreasing the circulating medium and lessening the demand for the products of domestic industry.

[4] *Ibid.*, pp. 165–6.

But it does not necessarily follow that whenever and as soon as our purchases abroad exceed our sales abroad, whether from tariff reduction or any other cause, we should raise the Treasury price of gold to stop the resulting gold outflow. There can be, on occasion, a very great advantage, at least for a while, in purchasing more than we are selling; and it may be possible to maintain such an "unfavorable" balance of trade for some time *without* subjecting ourselves to any deflation whatever.

This may be possible, for example, if the Federal Reserve banks have, at the beginning of such a movement, reserves much larger than they need. In that case, even though part of their reserves in gold certificates are relinquished to the Treasury in payment for gold, they may still have large enough reserves remaining so that they can help out member banks of the system and also, if desired—through open market purchase of securities—keep up the lending power of nonmember banks. Thereby they can maintain a circulating medium sufficient to hold a stable price level.

But even should the reserves of the Federal Reserve banks, along with reserves of other banks, be threatened with depletion because of purchase of gold from the Treasury, there need still be no restriction of bank credit, no decrease of circulating medium, no general decrease of demand for goods and no fall in the general level of prices. For as money is paid *in* to the Treasury for gold, an *equal* amount can be paid *out* in redemption of government bonds or otherwise, by the Treasury. Thus, the gold which has been hoarded by the Treasury can be used to purchase desired and useful foreign goods; while yet the paying out of the same *or new money* for bonds makes available as much domestic spending power for the purchase of American goods as if the gold were *not* being sent abroad. In other words, the American people can enjoy, during such a period, as much as they are able to produce *and also* all the foreign goods that can be purchased with the exported gold. Since we have, stored at Fort Knox, Ky., upwards of $20,000,000,000 in gold which we cannot very well eat or wear or use as productive capital, is there not something to be said for getting rid of a good bit of it if we can obtain, in exchange, useful capital and serviceable commodities?

There seems to be a fear, even among some economists, of a rivalry of nations in lowering the value of their currencies in terms of gold, *i.e.*, in raising the price of gold. There seems to be a fear that each country will seek thus to export more and import less. But if the argument herein presented is at all justified, any country which already *has* a large hoard of gold can gain greatly by releasing much or most of it for goods to any countr

or countries which thus stand ready to give goods cheaply for it; and yet the country which is so redeeming its currency in gold to be used for the purchase of goods abroad does *not* need to suffer deflation and it does not, therefore, have to suffer the evils of deflation.

Such an outflow to foreign countries of a vast hoard of gold will tend, of course, to a lowering of the value of gold—a rise of the prices of goods in terms of gold—in the countries to which the gold is flowing. This may bring the outflow to an end while the country having the large hoard of gold has some of the gold still remaining in its hoard. If, however, it appears that *all* the gold so stored is likely to flow out and if it is desired not to lose all of the gold, there remains the device discussed earlier in this paper, *viz.*, the raising of the official Treasury price of gold.

It is entirely possible, of course, given the will to do it and a reasonable understanding of monetary theory, for a country to maintain a substantially stable general level of prices without having any government hoard of gold or any official price of gold; with, in short, an inconvertible paper money. Purchase and sale of gold by government, with a readiness to change the official price of gold if and when circumstances warrant, is only *one* of the techniques by means of which the general level of prices may be kept stable. To quote again from my "Basic Principles of Economics":

> . . . The difference is that the price of gold, in relation to our money, changes by official pronouncement and government purchase or sale in any amount necessary to effectuate the official price, instead of merely unofficially in a general and independent gold market, as it would in case we had an irredeemable paper money with no official gold price at all. But, in either case, the price of gold is subject to change, so that great fluctuations in the world demand for or the world supply of gold need not upset the price level in the United States.[5]

It is to be hoped that the United States will not, now or at any time in the foreseeable future, enter into any currency agreement with any foreign country or countries which commits us to the maintenance of any *fixed* relation between our money and any given weight of gold. More fundamentally, it is greatly to be desired that responsible leaders of opinion in the United States come to understand the *importance* of stability in the general average of prices and the *comparative unimportance* of an unchanging Treasury price for gold. It is greatly to be desired that such leaders come to realize that a stable general price level and a fixed Treasury price for gold may sometimes be incompatible ideals. As I noted in my book:

[5] *Ibid.*, p. 165.

> It is not especially important that the dollar should always be worth a given number of grains of gold. It is of primary importance that the dollar shall be stable in its general purchasing power. And so, if and when gold fluctuates in its value in relation to other goods, it may be better that the dollar shall *not* be worth, continuously, a fixed number of grains of gold.[6]

And elsewhere in the same work:

> Certainly we ought not to be forever committed to a sacred and unchanging official price of gold. Yet there are still many men prominent as journalists or in public life or otherwise, whose pronouncements are listened to with respect, who seem to have learned nothing from the experience of the United States during the nineteen-thirties and who, when the conversation turns to monetary policy, can think of nothing but that the dollar should, under any and all circumstances, be kept equal in value to a given number of grains of gold.[7]

In truth, not a few such as these—possibly because of an instinctive conservatism—have written or spoken caustically of our "fifty-nine cent dollar" as if somehow the important matter were the amount of *one thing*, gold, which a dollar would buy rather than its *general* purchasing power. They have written or spoken as if the important matter were the change in the price of this *one thing*, gold, from $20.67 per ounce to $35 per ounce rather than what may have happened to the *general average* of prices. The dollar of 1934 and after, it is true, would buy only one thirty-fifth of an ounce of pure gold instead of almost a twentieth of an ounce which was what it would buy in the nineteen twenties and before. But following the high rediscount rates charged by the Federal Reserve banks in 1928–1929 and their open market sales of securities (both of which tended to decrease the volume of circulating medium), there came, from 1929 to 1932, a very great deflation of bank credit and a fall in the general average of wholesale prices in the United States of about a third; and prices remained throughout the nineteen-thirties lower than they were when the deflation began. In consequence, the "fifty-nine cent dollar" would actually *buy more* of goods-in-general than the "one hundred cent dollar" would buy in 1928 and 1929.

And so those conservatively minded commentators on money who can see no significance in its purchasing power over anything but gold seem like a man who, at noon of a clear day, with sunlight beating down on all the landscape for miles around, refuses to look anywhere except at the shadow cast by a tree—or, even, by a single leaf—and who insists against all common sense that the sun is not shining at all!

[6] *Ibid.*, p. 66.
[7] *Ibid.*, p. 118.

IV

WHAT IS NEEDED is substantial stability of money in terms of goods-in-general, to the end that borrowers shall not gain at the expense of lenders from rising prices, nor lenders gain at the expense of borrowers from falling prices and to the end that sharp decrease of circulating medium shall not bring acute business depression nor great and rapid increase bring the speculative mania of inflation. And the thesis of this paper is that there is no incompatibility between such price level stability and the fullest degree of free trade.

But if we plan sometimes to use the technique of *raising* the official Treasury price of gold as a means of preventing *deflation* and *falling prices* from an *outflow* of gold to foreign countries, we should be equally willing to *lower* the price of gold as a means of preventing an *inflow* of gold which would bring *inflation* and *rising prices.*

Let us suppose, for example, that new and rich gold mines are discovered abroad and that, in consequence, foreign nations for a time purchase much more from us than we do from them, paying for these excess goods by sending gold. In that case

> . . . *Even though we no longer coin gold in the United States, the same result, viz., increased circulating medium and rise of prices, is realized when the government buys gold with gold certificates.* In practice, those whose sales of goods abroad in excess of American purchases abroad make the importation of the gold possible, dispose of their claims on their foreign customers to American banks, *in exchange for increased checking accounts.* The banks then import the gold and sell it to the government through a Federal Reserve bank; or they may sell to a Federal Reserve bank (or banks) their newly purchased claims on the foreign customers of their depositors, in which case the Federal Reserve bank (or banks) will import the gold and sell it to the government. Thus in the end, in any case, certain individuals or business firms have larger deposits, their banks have larger claims on (reserves in, if they are member banks) a Federal Reserve bank (or banks) and some Federal Reserve bank (or banks) has increased gold certificates.

The fundamental relations are the same when, as quite commonly happens, a foreign bank takes the initiative and sends gold to the United States. Thus, suppose the Bank of England ships gold to the Federal Reserve Bank of New York. The Federal Reserve Bank of New York sells the gold to the United States Treasury and thereby secures a larger reserve, in the form of gold certificates. The Bank of England now has a credit claim on, *i.e.*, a deposit in, the Federal Reserve Bank of New York. This claim or deposit can be drawn upon (the Bank of England selling bank drafts—really its own checks—on it) to pay for American goods which are purchased by British firms or, as in the case of military supplies, by the British government. The American sellers of the goods deposit the claims (bank drafts)

they receive, in their banks. These American sellers of goods then have larger deposits. Each member bank sends the claims so deposited in it, to the Federal Reserve bank of its district (which bank, in turn, demands settlement from the Federal Reserve Bank of New York), for credit. Thus the member banks have larger reserves.[8]

Such a flow of gold in return for goods sent abroad must tend to raise the price level in the United States. But, surely, there is no wisdom in sending out to foreign countries, month after month and, even, year after year, the products of American farms, factories and mines and getting in return nothing to use or enjoy but only billions of dollars worth of gold to be stored indefinitely at Fort Knox. And when this increase of gold is the means—through its sale to the Treasury for increase of bank reserves and resulting greater lending power of the banks—to inflation of the currency and rise of prices, then there is not only the general economic loss just referred to but, further, a discrimination against lenders and other recipients of fixed money incomes.

Rather than let such an inflow continue, the price offered for gold by the Treasury should be *lowered* sufficiently to stop its coming. When gold sent from abroad will buy a smaller amount in American money, the prices of American goods, even though no higher in American money, *are higher for foreign purchasers.* A properly adjusted reduction in the Treasury price for gold will serve to prevent foreign purchase of American goods with gold and will encourage American purchase of foreign goods. It will restore the condition which is the long run norm, *viz.*, that *foreigners purchase all the goods and services they can pay for with the goods and services* (other than gold) *which we purchase of them.* And it will restore that normal equilibrium without the necessity of an intervening period of increasing circulating medium and rise of the general price level. Certainly there is no justification for the view that the United States Treasury should stand ready to buy gold without limit, under any and all conceivable circumstances and at a fixed price.

I am not trying to argue here that every slightest inflow or outflow of gold should be the signal for a change in its official price. There are various other controls—*e.g.*, the Federal Reserve banks' rediscount rates, open market operations, raising or lowering reserve requirements of member banks—which may oftentimes suffice and be preferable. But I *am* contending that the official price of gold ought not to be rigidly fixed but, instead, ought to be subject to change whenever this is the only or the best way of assuring price level stability.

[8] *Ibid.*, pp. 113–4.

X

The System of Free Enterprise and Its Caricature

THE system of free enterprise ("capitalism") seems to receive a good deal of lip service from business executives. And it has the tacit—if nevertheless uncomprehending—support of those farm owners and owners of other property who dread the thought of socialism or communism.

But the kind of "free enterprise" system which many of the more vocal opponents of socialism and communism appear really to want is, at best, a miserable caricature of what a free enterprise system might be and ought to be. Each economic group is so intent on interferences with freedom, in its own group or class interest, that the end result can hardly be considered a free enterprise system at all. In various respects, it is already regimented much as socialism or communism would be although doubtless not to the same extent, and certainly it is not regimented advantageously to the poorest class with whose welfare advocates of communism—and socialism—feel they are especially concerned.

But these general statements will probably mean little to most readers unless accompanied by some sort of bill of particulars.

I

LET US BEGIN by considering the Agricultural Adjustment Acts of the New Deal. The provisions of these statutes certainly have interferred and those of the later statute under this title do interfere with the normal operation of the voluntary price or free enterprise system.

Under the original Agricultural Adjustment Act, passed in 1933 in the early days of the New Deal, owners of farms were paid a bounty or subsidy by the federal government to take land out of use. One result was that not a few landlords—especially owners of plantations in the South—found it desirable to dismiss or discharge a considerable proportion of their tenants and laborers. The workers thus deprived of employment on the plantations and farms had then, in a period marked by widespread unemployment, to seek other jobs.

The purpose of the law was to *hold up* and even to raise appreciably the prices of agricultural products by *limiting* their *supply*. This is the method of *privately* established monopoly, too, and it is no more desirable or defensible when practiced by government than when practiced by individuals or by private companies.

As I have pointed out in my "Basic Principles of Economics,"[1] it is sometimes argued in this connection

> that since some manufacturers may have had a degree of monopolistic control and may have been able to restrict output and hold up prices, and since wheat farmers have been unable thus to establish monopoly by themselves, therefore the government should aid them to restrict the output of wheat so as to hold up wheat prices. The result may, of course, be a benefit to certain wheat growers, but life is thereby made harder than before for those persons who, not being in any privileged group themselves, must now contribute to a new privileged group just because they have previously had to contribute to an old one.
>
> When individuals or small groups succeed by burglary, picking pockets or holdups, in abstracting wealth from others, those who are robbed at least have law on their side. But what if a larger and politically powerful selfishly interested group succeeds, by sophistical arguments, or by legislative bargaining with other selfish groups seeking privileges at the expense of the general public, or merely by gaining the support of legislators who are more afraid of losing the votes of an active and well organized privilege-seeking minority than of an unorganized and comparatively unaware and inert majority,—what if such a group thus succeeds in using the tax system and the legislative appropriation machinery to abstract wealth from the rest of the people! In such a case, those from whom wealth is being abstracted find that even the law is against them and that, if they refuse to make the required tax contribution, it is they, and not those profiting at their expense, who are considered the criminals.
>
> What if there should be a continued and progressive extension of government interference, regimentation and control in the interest of such privilege-seeking groups! Might we not finally discover, as we approached the end of this unhappy journey, that men's incomes depended mostly on their skill in political bargaining, threats and chicanery, and scarcely at all on their productive efficiency? And would it not then be widely argued that the voluntary price system ("Capitalism") had failed, and that the state must henceforth control all those economic activities which were previously guided, in a régime of economic freedom, by the market and by the lure of price?

If it were really conducive to prosperity to withdraw good land from use, does it not follow that the United States would be more prosperous if a Sahara desert were substituted by nature for a large part of our good farm land?

Indeed, such a calamity *would be a definite advantage* to the owners of what good land still remained. For in such a case the frantic competition of the landless for the use of land to work on would enable the

[1] Lucas Brothers, Columbia, Mo., 1942, pp. 171–172.

landlords to *charge higher rents* to tenants and *pay lower wages* to laborers!

But after all, the thought that substitution of a Sahara desert for much of the good land in the United States would be a general benefit is consistent *not only* with the policy of paying landlords to take their land out of use. It is consistent *also* with our long continued encouragement of the holding of land out of use by speculators. Within and about American cities are vast numbers of vacant lots, many or most of which will remain vacant for years and not a few of which will remain vacant for decades. These lots have been made, usually, unutilizable for agriculture. They do not serve, in any proper sense, the function of public parks and children's playgrounds! Nevertheless, their existence involves the extension of telephones and electric light wires and of gas, water and sewer mains over longer distances. It involves the necessity of walking or riding longer distances from home to work and from work back home on the part of thousands of city dwellers. It involves longer distances traversed for the delivery of purchased goods to the homes of purchasers and for the collection and delivery of laundry.

If we had the will, we could easily enough make the speculative holding of vacant land altogether unprofitable. A high land-value tax, levied in place of some of the burdensome and economically depressive taxes we now have, would accomplish the purpose completely and, indeed, would have various other definite advantages,—such as lowering the sale price of land and making easier the transition from tenancy to ownership of land by the user of it.

Is it really surprising, however, that a generation which will not even seriously consider such a reform should go still further in the encouragement of holding land unused, by providing that the rest of the public should be taxed in order to *pay* landlords for withholding land from use?

Let those anti-New Dealers, then, who are inclined to criticize the New Deal political leaders for their policy in regard to farm land, ask themselves how *they* feel about the economic waste of vacant land speculation! Here, perhaps, is the acid test of their understanding and sincerity!

II

WE NOW HAVE a new Agricultural Adjustment Act (1938), the first one having been declared unconstitutional by the Supreme Court. But the amended Act also—though not by paying subsidies for taking land completely out of use—applies the principle of limiting output for the

purpose of holding up or raising prices. Subsidies are now paid for the planting of "soil restoring" and "soil maintaining" crops. This is somewhat as if owners of houses were paid subsidies for "restoring" their roofs by putting on new shingles and "maintaining" their walls by painting them! But the newer Act also makes provision for "quotas" to apply to the growers of wheat, corn, cotton, rice and tobacco. Those who produce and sell more than the quotas allotted to them are penalized by a heavy tax,—in effect, a fine. This, certainly, is supply-limiting legislation.

There is, in the Act, a sharp limitation of the amount of a particular crop—when quota limitations are voted—which can be produced in a county or state on land not recently used to grow that crop. For example, not more than three per cent of the county acreage allotment for wheat may be apportioned to farms on which wheat has not been planted during one or more of the three previous marketing years. In the case of cotton, not more than two per cent of a state's acreage allotment may be apportioned to farms which were not used for cotton production during at least one of the three preceding calendar years.

In the case of rice, the prohibition is against persons rather than particular pieces of land. Here it is provided that not more than three per cent of the acreage allotted to any state shall be apportioned "among persons who for the first time in the past five years are producing rice on the basis of the applicable standards of apportionment" and that no such person shall be allowed more than seventy-five per cent of the acreage in rice he could have if this were not the first time in five years he was so producing.

It can easily be seen that, when such a limited quota for all those persons who have not produced rice for five years has been asked for and allotted, an American citizen whose application was a little later would not have the *liberty* to produce rice *at all* for that year. As regards wheat and cotton, an American citizen desiring to produce one or the other of these and buying or hiring a piece of land for the purpose, might find that he was *not free* to produce the crop *on that land* because the particular piece of land had not been so used in recent years and because the acreage allowed for such land was all allotted.

Will our ultimate economic system be one in which *every* person is told in what industries he *may* engage *and* what occupations he must perforce *forego?* And this in a country where the words of the Declaration of Independence are still given lip service:

"We hold these truths to be self evident; that all men are created

equal; that they are endowed by their Creator with certain inalienable rights; that among these are life, *liberty*[2] and the pursuit of happiness."

The question whether to establish a quota in any year is determined by the Secretary of Agriculture, with the proviso that the quota will not go into effect if opposed in a secret ballot by more than one-third of the farmers affected.

This arrangement has been euphemistically described on *very* high administration authority as "the democratic way." But to describe it thus is really a travesty on the word "democratic." *Consumers* do not vote on the matter. Millers (or other processors) do not vote on it. Would-be farm laborers for whom such quotas may mean no farm jobs do not vote on it. If such a system of deciding that there shall be a monopolistic limitation of output is "democratic," then it would be "the democratic way" for the various gasoline companies to decide, by secret ballot, whether to limit the output of gasoline and for the owners and operators of coal mines to decide in like manner whether to limit the output—and thus raise the price—of coal. Has it really become "democratic" nowadays to shut out from decision on such matters millions of consumers whose economic interests are acutely affected by the decisions reached?

When competitive forces are allowed to work themselves out without interference from government restrictions, prohibitions and quotas, excess production of any kind of goods operates to bring its own correction and, therefore, tends to be only temporary. For the resulting low price means smaller returns to those engaged in the business and these smaller returns induce some of them—presumably those relatively *not so well adapted* to it and, also, the capital and land relatively *not so well adapted* —to leave this line of production for various other lines.

But when this fact is pointed out, the objection is frequently raised that, largely, workers cannot and will not change, that labor is "immobile," and that the economists who say they can and will move are *"laissez-faire"* economists who base their conclusions on mere "theory" rather than on observed facts.

Actually, it is the critics of these economists who fail to observe the facts. For just a little observation of what goes on about them daily ought to convince them that changes in occupation are by no means infrequent but are, in fact, common. And there is, too, in every year, a flood of unspecialized beginning workers who can go into one or another

[2] The reader will recognize that the present writer has introduced italics.

line according to where lies the greatest promise of substantial income. The recent rush of many thousands—not to say millions—of workers into war industries previously unfamiliar to them offers an illustration of mobility on a vast scale. And in case the critics attempt to escape the logically inevitable conclusion by referring to this mobility as resulting from "abnormal" (*i.e.*, war) conditions, then they should be required to note the migration from country to city between 1922 and 1930. During these eight years an average of about two million persons a year left the farms for the cities while an average of well over a million a year moved in the reverse direction, leaving a net movement from the farms of about two-thirds of a million annually.[3] Certainly, when there is such mobility as this, it is ridiculous to assume that the great majority of farmers cannot even change from one crop to another!

If, during the thirties, there was no such movement to the cities, this was almost certainly because of business depression in the cities, with wide unemployment and low average income.

III

HERE WE MAY NOTE briefly another angle to our sabotaging of the free enterprise system ("Capitalism"). This is that we have followed policies calculated to bring about recurrent depressions, with their incident failures and unemployment. Bank credit deflation has, indeed, brought drastic decreases in prices of raw materials, including farm products, and farmers have certainly suffered acutely from such deflation. But so have jobless city workers and various other persons.

If it is a proper function of government to establish standards of length, volume and weight, it is also its proper function to establish, as nearly as may be, a stable standard of value. This means that the money and banking system should be so controlled as to avoid either inflation or deflation.

But having failed to perform this essential function of providing a stable standard of value and having thus contributed to the genesis and development of alternate inflations and deflations and of business depressions, the federal government has then tried to rescue a part of us from some of the evil consequences of its neglect by policies which have brought further injuries to others of us, which deprive our citizens of long-accustomed liberties and which are utterly inconsistent with the system of free enterprise and individual initiative to which not a few of our business leaders attribute our industrial dominance.

[3] See U. S. Department of Agriculture, *Agricultural Statistics*, 1939, p. 484.

Our labor policy, also, has been not too intelligent. The Federal Fair Labor Standards Act of 1938 fixed wages per hour on an appreciably higher basis than had been previously enjoyed by the lowest paid workers in a considerable part of the country. To illustrate the effect such a minimum wage law may have, let us suppose the case of a coal mine worker the hiring of whom by an operating company will increase its output by not more than one ton of coal per day. At the mine mouth, with transportation and marketing costs to subtract from the retail price, the coal is worth only $3.00. If legislation makes it a misdemeanor to hire this worker for less than $4.00 per day—or even less than $3.20 per day—will the company hire him? Will he be hired if to hire him means he must be given $4.00—or even $3.20—for producing something that cannot be sold for more than $3.00? Surely wage-raising laws *must* bring about unemployment whenever the increased wages so required are higher than the value of the goods or services for which they are paid.

The economically illiterate may object to this view on the ground that in order to raise wages we have only to increase prices!

Even though we assume that we could increase money wages by increasing proportionally the prices of goods, this would not mean any increase in the *real* wages (food, clothing, phonographs, refrigerators, motion picture entertainment, etc.) of workers and it is *real* wages which are important.

But without an increase in circulating medium (money and bank credit), we could not expect a rise of prices *unless it occurs in consequence of decreased production.* Do we desire decreased production and concomitant forced unemployment for many of our wage earners in order that we may have a scarcity of goods, in order that the prices of these goods may thus be kept high and in order that those workers who are lucky enough to be still employed may receive wages higher in dollars with which to purchase goods at these proportionately higher prices?

Unless there is increase of circulating medium, then, making possible a rise of commodity prices, or unless the productiveness of labor quickly increases so that the higher wages are really earned, a law requiring that wages be raised appreciably above the level measuring the value of what labor produces must increase unemployment; and it might increase unemployment very greatly.

But, as suggested above, a sufficient increase of circulating medium, *i.e.*, a sufficient *inflation,* would operate to rescue the wage earning population from the evil consequences of such a law. For such inflation would

raise the general level of prices of the goods the labor produces and would thus make it possible to pay the wages which the law required.

Perhaps the Fair Labor Standards Act passed by Congress in 1938 has thus been, is being and will be kept from greatly decreasing the opportunities for employment. For since this Act was passed there has been a very considerable degree of inflation and it is not unlikely that there will be more. The Act fixed a minimum wage of 25 cents an hour, to become 30 cents per hour in 1939 and a minimum of 40 cents per hour in 1945. If, when the law went into effect in 1938, the provision that wages must not be less than 25 cents an hour was intended to have any effect at all in raising the wages of unskilled labor above what they already were in any part of the United States, must not 40 cents an hour, *in the absence of any rise of prices,* necessarily bring some degree of unemployment? And what if prices actually fell between 1938 and 1945 as they did greatly between 1926 and 1932!

If all that is necessary to improve the economic status of workers is to legislate wages upward, why not pass a law that no one shall pay wages of less than $1.00 an hour, or $10.00 an hour, or even $100.00 an hour! Or might it be, conceivably, that the view that we can force wages up greatly by law while still maintaining full employment, is just wishful thinking?

The Fair Labor Standards Act, however, does not apply to all industries. The statute specifically states that the minimum wages fixed are not to be required in certain occupations, *e.g.,* agriculture and retailing. It would still be possible, therefore, for a worker deprived of employment in (say) manufacturing or mining by the requirements of the Act, to work on a farm, where the wages can be—so far as the law states—as low as or lower than a cent a day, or to work in a retail store. Thus, we might expect to find some workers who were forced out of manufacturing and mining going into these other lines of work, increasing the competition for jobs in these other lines, and making wages in them even lower than such wages would be if the Fair Labor Standards Act had never been passed!

But here we come again face to face with the Agricultural Adjustment Act and the "quota" limitations of output provided for by it. By means of such quotas the opportunities of men to find employment in some lines of agriculture are reduced. And, obviously, the larger the number of lines of production from which workers are excluded, whether by minimum wage laws or by quotas or otherwise, and the fewer the lines of

production into which they are permitted to go without restriction, *the greater is the tendency to press wages down in the fields still remaining open!*

Just as the quota system of the Agricultural Adjustment Act was euphemistically presented as "the democratic way," so has this fixing of wages been euphemistically described as putting "a floor under wages." But such a "floor"—if it does really and effectively require a wage level appreciably above the level of a free market—must either occasion large unemployment or, in case the wages fixed apply only to some lines of labor, must tend to crowd workers into other lines and so reduce wages in them. Limitation of the number of workers that can be employed in some lines must operate to the disadvantage of workers excluded and, in general, to workers in other lines, regardless whether the limitation is the policy of a monopolistically inclined union or is the policy of government acting under pressure from agriculturists, labor groups or just sympathetic "liberals."

IV

BUT CERTAINLY it is not only under pressure from the spokesmen of farmers, manual labor groups and the sympathizers of these that legislatures apply restrictive policies. They do it as well under pressure from various business groups. A recent type of restriction is the heavy tax applied to chain store companies. In a number of states the tax on each store of a chain increases up to the point where added stores are taxed $500.00 a year each, or even more. It does not appear likely that this is done because of any serious fear of monopoly. The various chain stores compete with each other and they have to meet the competition, also, of efficient independent stores. But owners of independent stores who would like to be *relieved of competition* from *a very efficient system of goods distribution* are too eager and ready to bring pressure on legislatures for restriction on such competition. The to-be-expected consequence is higher prices or poorer service to consumers,—or both.

Another illustration of the results of such pressure is to be found in our so-called "fair trade" legislation. Here, too, we are treated to euphemistic phrase making. What "fair trade" laws really mean is that manufacturers are permitted to dictate the prices that dealers may charge for the special goods made by these manufacturers, so that *a more efficient dealer cannot express that efficiency in a reduction of the retail price.*

Still another, and certainly an old and familiar restriction of competition, is the so-called protective tariff. The economic objections to such

legislation have been presented most effectively over and over again since the appearance of Adam Smith's "Wealth of Nations" and earlier. But the policy is still followed in every or almost every country. Indeed, one of the economic evils of the Treaty of Versailles following World War I was that, in setting up new nations on the basis of "self determination of peoples," it increased the number of national boundaries at which tariff restrictions could be and were levied. And in our own country, though we do not have, formally, protective tariffs between the separate states, we do have vexatious and conflicting truck regulations, multiplied license fees for trucks going through several states, heavy taxes in some states on certain goods that are the products of other states, inspections and inspection fees at state borders, etc. Perhaps in an earlier era the Supreme Court would have summarily forbidden such interferences as being merely camouflaged violations of constitutional provisions which were supposed to guarantee free trade among the states. But our present "liberal" Court seems inclined to allow them unless or until Congress asserts itself by some form of national control. Presumably, if and when Congress sets forth a broad federal policy in regard to interstate trade and all of its necessary mechanisms, such as trucks, any conflicting state regulations will be ruled out.

The system of free enterprise, at its possible best, would be a system in which individuals were free to choose their occupations and to produce as much or as little as they pleased of whatever they pleased.[4] (How much we have already departed from this, and how hard it is, against the pressure of interested groups or blocs, to retrace our steps!) It would be a system that relied for the provision of desired goods on the lure of profitable price, and for drawing labor into a desired line of production on the lure of relatively high wages. It would be a system in which men were free to save and to invest in the construction of capital or not to do so. It would be a system in which monopolistic restriction of output either by conspiring business groups or by government in the interest of privileged groups was impossible. It would be a system in which really unfair competition, *e.g.*, misrepresentation of rivals' goods, discriminating transportation rates, etc., was outlawed and effectively suppressed. It would be a system in which, in general, the enjoyment of large income was the result of offering large and desired service,—of efficiency in meeting the needs and desires of the public. It would be a system, therefore, in which men could do best for themselves and

[4] Save for restrictions on obviously injurious drugs, the tools of crime, etc.

their families and the causes in which they were interested, by being the best possible servants of the community.

Before concluding this discussion, it should be pointed out that one of our policies which is *most inconsistent* with the principles a system of free enterprise ought to exemplify, is our policy regarding land, land rent and taxation. To allow individuals to receive income for effort contributed in production is consistent with this system. To see to it that individuals can receive income from capital which, except for their saving, would not have been brought into existence and which adds to the annual output of desired goods is equally consistent with this system. But so to arrange matters that individuals receive income because they are in a strategic position to make others pay them for *permission* to work and to live *on the earth* and to enjoy *community-produced* advantages of location, is definitely *not* consistent with this system. Nor is the interference with effective production, which comes from the speculative holding of land out of use, consistent with this system.

Pretended friends of the system of free enterprise may urge heavy taxes on the goods men buy, on the incomes—even very small ones—they earn by hard work, and on capital and the income from capital,—in order that taxes on the geologically-produced and community-produced rent of land may be kept low. But no such policy can be urged by anyone who, with sincerity and understanding, seeks to further the development of a system of free enterprise consistent throughout with the ideals on which alone it can be convincingly defended.

APPENDIX

APPENDIX

Economic Rent: In What Sense a Surplus?

Students of economics have long been handicapped by the fact that many of its terms are used, by various economists, in widely different senses. Even when a term seems to have acquired a clear and definite and generally accepted meaning in the craft of the economists, there is no guarantee that innovators will not adopt a new meaning for it and be extensively imitated.

It has been so with the word "rent" which, to the classical economists, meant rent of land but which, about the turn of the century, began to be applied to the yield of produced capital. As the then "modern" and "up-to-date" economists of about the year 1900 began to blur the distinction between land and produced capital and between the income from the one and from the other, and to follow the man in the street in using the term "rent" for both, it was still possible for those of us of a different point of view to make ourselves clear by referring to "economic rent." By using the modifying word "economic," we could still make clear that we were referring to the yield of land as such, *i.e.*, of land in the strict economic sense, exclusive of improvements made by an owner or tenant *in* it as well as *on* it.

But now it begins to look as if even this privilege is to be denied us and as if once more the very terms by which we have tried to emphasize a distinction we have considered important are to be appropriated and turned to other purposes by economists who have no sympathy with us. Indicative of this apparent trend is the recent book by Professor Kenneth E. Boulding of Colgate University, entitled *Economic Analysis*.[1] To Professor Boulding, economic rent is not just the yield of land ownership—indeed, he seems to feel that much of this yield is not even to be included in it—but rather is "any payment to a unit of a factor of production in an industry in equilibrium, which is in excess of the minimum amount necessary to keep that factor *in its present occupation*."[2]

Professor Boulding makes it very clear that he regards wages as, in part, economic rent. Many workers would stay in the *particular line* of work they are in, even at appreciably lower wages than they now receive, and the excess over the amount necessary to keep them in that particular line is economic rent. Boulding illustrates by reference to the occupation of weaving, in which, at $20 a week, he supposes 1,000 willing to work, each extra dollar per week increasing by 100 the number of men "willing to work at weaving."[3] And, according to Professor Boulding: "The higher the wage, the greater will be the economic rent received by all those workers who would be willing to work at a lower wage, and the greater will be the economic rent received by all workers."[4]

[1] New York, Harper, 1941.
[2] *Economic Analysis*, p. 229. The italics are mine.
[3] *Ibid.*, p. 230.
[4] *Loc. cit.*

On the basis of such a presentation, a very large part of the rent of land wou definitely *not* be "economic rent." And so the expression "economic rent" com clearly to *exclude* a large part of what, originally, it was specifically chosen mean! For whenever a piece of land can be used almost equally well to produ two or three different kinds of goods, any appreciably lower yield from th land in one use than in the other or others would cause the land to be withdrav from such use. And so the owner of a piece of land in a centrally located businc block of a large city who derives (say) $20,000 a year on the land from tenant who uses it for a particular kind of merchandising, but who could deri $19,900 a year if the land were used for another kind of merchandising or f banking and finance, does not really have $20,000 of economic rent but only $10

Any part of the price of a commodity which is necessary to keep the work *or* the capital *or* the land in the business of producing *that particular commodi* for sale is *not* economic rent in the view of Professor Boulding.[5]

Yet on a later page of his book the author *includes* in "economic rent" a co siderable part of what he has previously *excluded*. For on this later page l defines economic rent as "any payment to the owner of a factor of production excess of what is required to keep that factor *in continuous service*."[6] Here l does *not* say "in its present occupation." And the context is consistent with tl new definition. For, advising that the legislator should "wherever possible, atta economic rent,"[7] and expressing the opinion that "a properly constructed i come tax falls to a very large extent on economic rents,"[8] he immediately goes (to say:[9] "In so far as it applies to all occupations it does not affect *relati* profitabilities, and so cannot be escaped by shifting occupation." By fairly cle implication, then, as well as by his second formal definition, it would seem th Professor Boulding considers that part of a taxpayer's income which can be th successfully taxed away from him to be economic rent.

Perhaps we should not be unduly critical of a careless slip into an inconsiste taxonomy. But it does seem unfortunate that the expression "economic rent" now coming to be twisted, by some writers, out of all semblance to the meanir which has usually been given to it. Does not this inevitably tend to confu students of economics? And does it not tend to turn their attention away from tl problem of who should enjoy the rent of land?

When "economic rent" is taken to mean the rent of land exclusive of indivi ually made improvements in or on the land, it is natural to ponder the questic how such rent differs from income produced by work or income attributab ("imputable") to constructed capital. A considerable number of students c economics have come to the opinion that the rent of land (so understood) is pro erly to be regarded—with only insignificant qualifications—as an *unearned* i come, an income not received in return for any service given to those from whoi it is drawn. The wages of labor, on the other hand—although it is to be reco

[5] *Op. cit.*, p. 232.
[6] *Ibid.*, p. 787. The italics are mine
[7] *Loc. cit.*
[8] *Loc. cit.*
[9] *Loc. cit.*

nized that some labor is devoted to anti-social ends—and the yield on constructed capital are, in general, *earned* by equivalent service given.

But now we have our attention turned away from the contemplation of such distinctions as this into the question whether it would not be possible for the state to take a large part of the earnings of labor without thereby causing the workers to cease working. We no longer are urged to inquire—certainly such writers as Professor Boulding do not urge this—whether it is socially desirable that incomes enjoyed by the citizens of a country shall have any close relation to their productive contributions. Instead, the question is how much can we squeeze out of them, even of what they fairly earn, while yet not causing their labors—or their savings—to cease (wholly or in large part). What if a large group of men are completely enslaved, either by individual masters or by government, and so are forced to work by the lash or the knout? Is *everything they produce beyond enough to maintain their ability to work* to be regarded as "economic rent"?

One wonders if this recent concept of "economic rent" is in some sense—though, of course, not consciously—part of the current swing toward social control, toward regimentation, toward totalitarianism.

Is the expression "economic rent" now to do duty for every sense in which we may say that there is a "surplus"? If so, what can the economist who believes the distinction between income from land ownership and other income to be important do about the matter? Will he, for long, be permitted the use of *any* term to express his meaning?